The Regulation of Credit Rating Agencies: An Analysis of the Transgressions of the Rating Industry and a Measured Proposal for Reform

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THE REGULATION OF CREDIT RATING AGENCIES: AN ANALYSIS OF THE TRANSGRESSIONS OF THE RATING INDUSTRY AND A MEASURED PROPOSAL FOR REFORM

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Abstract

In February 2015 the U.S. Department of Justice confirmed that it had reached an agreement with Standard & Poor’s, the largest credit rating agency, so that it would pay a record $1.375 billion fine for defrauding investors during the Financial Crisis. This record fine has been heralded as an indicator of the State’s ability to effectively punish transgressions within the financial markets. However, upon closer inspection, the credit rating agencies have continued transgressing. Therefore, this thesis aims to show why this discipline has been ineffective in terms of impacting upon the credit rating agencies’ appetite, and ability, to transgress. In focusing upon one small, yet significant, aspect of the credit rating industry, this thesis examines the effect of ancillary service provision upon the conduct of the credit rating agencies.

It is found that the revenues and profits garnered from the ancillary service divisions of Standard & Poor’s and Moody’s far outweigh the record fines that are being given to them. This fact, when combined with the understanding that these divisions have no positive impact upon the transparency, or indeed the accuracy of credit rating agency output, means that the discipline deemed appropriate by the State is being entirely nullified by divisions that can be removed; this thesis therefore calls for that removal and presents a detailed proposal to that end.

This thesis embarks upon this endeavour in an attempt to reduce the ability of such a critically-important component of the financial sector to transgress. This is important because the impact of destructive finance upon society in 2008, and ever since, has not been witnessed since the Great Depression. In order to spare society from bearing the brunt of another collapse because of the iniquities of the marketplace, this thesis also calls for the reimagining of the economic reform process so that the safeguarding of society, and in particular the most vulnerable in society, is prioritised over the extraction of wealth by a small number of people.

List of Abbreviations

A.B.S. – Asset-Backed Security

A.I.C.P.A. – American Institute of Certified Public Accountants

B.I.S. – Bank of International Settlements

C.D.O. – Collateralised Debt Obligation

C.D.S. – Credit Default Swap

C.E. – Credit Enhancement

C.F.M.A. Act of 2000 – Commodity Futures Modernisation Act of 2000

C.M.B.S. – Commercial Mortgage-Backed Security

C.R.A. – Credit Rating Agency

C/F – Conduit Fusion

CalPERS – California Public Employees' Retirement System

D.B.R.S. – Dominion Bond Rating Service

D.o.J. – Department of Justice (U.S.)

D.S.C.R. – Debt Service Coverage Ratio

E.D.F. – Expected Default Frequency

E.D.S. – Equity Default Swap

E.S.M.A. – European Securities and Markets Authority

F.D.I.C. – Federal Deposit Insurance Corporation

F.D.R. – Franklin Delano Roosevelt

G.A.O. – Government Accountability Office (U.S.)

G.S.E. – Government-Sponsored Enterprise

I.N.C.R.A. – International Non-Profit Credit Rating Agency

I.O.S.C.O. – International Organisation of Securities Commissions

L.G.D – Loss Given Default

L.O.L.R. – Lender of Last Resort

M.A. – Moody's Analytics

M.I.S. – Moody’s Investors Service

N.C.O. – National Credit Office

N.I.N.J.A. – No-Income No-Job or Assets

N.R.S.R.O. – Nationally Registered Statistical Rating Organisation

N.T.M. – Non-Traditional Mortgage

O.C.C. – Office of the Comptroller of the Currency

O.E.C.D. – Organisation of Economic Co-Operation and Development

O.P.E.C. – Organisation of the Petroleum Exporting Countries

O.T.S. – Office of Thrift Supervision

P.C.A.O.B – Public Company Accounting Oversight Board

P.D. – Probability of Default

P.I.T. – Point in Time

Q.I.B. – Qualified Institutional Buyer

Q.P. – Qualified Purchaser

R.M.B.S. – Residential Mortgage-Backed Securities

S&P – Standard & Poor’s

S.E.C. – Securities and Exchange Commission (U.S.)

S.I.F.M.A. – Securities Industry and Financial Markets Association

S.I.G.T.A.R.P. – Special Inspector General of the Troubled Asset Relief Program

S.I.V. – Structured Investment Vehicle

S.O.X. – Sarbanes-Oxley Act of 2002

T.A.R.P. – Troubled Asset Relief Program

T.T.C. – Through the Cycle

Diagrammatical Data

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17 C.F.R. 240.15c3-1 (Net Capital Requirements for Brokers or Dealers)

An Act to Further Amend the National Banking Laws and the Federal Reserve Act (McFadden Act) Pub.L. 69-639 H.R. 2 (1927).

Investment Company Act of 1940 Pub.L. 76-768 2(a)(51)(A).

Regulation (EU) No 1060/2009 [2009] OJ L302/1.

Regulation (EU) No 462/2013 [2013] OJ L146/1.

Regulation (EU) No 513/2011 [2011] OJ L145/30.

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 Pub.L. 103-328.

Sarbanes-Oxley Act of 2002 116 Stat. 745.

Securities Act of 1933 Pub.L. 73-22, 48 Stat. 74 Rule 144A.

The Banking Act of 1933 Pub.L. 73-66, 48 Stat. 162.

The Commodity Futures Modernisation Act of 2000 H.R. 4577.

The Community Reinvestment Act of 1977 Pub.L. 95-128, 91 Stat. 1147.

The Credit Rating Agency Duopoly Relief Act of 2005 H.R. 2990.

The Credit Rating Agency Reform Act of 2006 Pub. L. 109-291, 120 Stat. 1327.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 Pub.L. 111-203, H.R. 4173.

The Gramm-Leach-Bliley (Financial Services Modernisation) Act of 1999 Pub.L. 106-102, 113 Stat. 1338.

The Housing and Community Development Act of 1992 H.R. 5334.

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There are a number of people who, through my professional development, have become extremely significant to me both in terms of support and inspiration. The first person I would like to thank is Ms Abigail Stewart. It was in Abigail's 'Corporate Governance' module during my LL.M. that I was introduced to the rating industry; a moment that would reform the basis of my life from that point onwards. Abigail's support ever since has been unfailing and sincerely appreciated; her approach to education and how to conduct one's self has been a source of inspiration. Next I would like to thank two people who I met during my B.A. in the University of Liverpool. Dr Diane Frost and Professor Jason Powell, both of who lectured me, have gone on to be truly important in my development and have supported me throughout; their efforts were, and continue to be invaluable for me. I would also like to thank Professor David Held for providing me with advice and support since I have been in Durham; his general approach to life is remarkable and his humility, foresight, and professionalism were a key source of inspiration as I navigated my way through the different stages of the PhD process.

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I conclude my acknowledgements by dedicating this thesis to my Mother, Jane. There are simply no words to express my thanks to her. Her demonstration of fortitude, humility, humanity, foresight, commitment and belief in education, and ultimately her will and determination for her children to succeed, against all odds, is truly awe-inspiring and has, and always will be, an abiding inspiration. This thesis, and everything else I do, is for her.

Introduction

"This historic settlement makes clear the consequences of putting corporate profits over honesty in the financial markets"[1]

The statement above is taken from the press release in February 2015 from the U.S. Department of Justice (DoJ), which was announcing that the DoJ, along with 20 States, had reached an agreement with Standard & Poor's (the largest credit rating agency by way of market share), which would see it pay a record \$1.375 billion as a fine for its conduct in the lead-up to the recent financial crisis. The settlement, which was to resolve allegations that 'S&P had engaged in a scheme to defraud investors in structured financial products' is by far and away the largest fine ever given to a credit rating agency. However, the statement above contains an issue that is the raison d'être for this thesis; are the consequences that this historic settlement 'makes clear' enough?

There is a tendency for those who are concerned with analysing the credit rating industry to focus upon the magnitude of the fines that have been imposed, or on the choice between fines and other forms of punishment (such as imprisonment) but, although each of those issues have some validity when assessing the ratings industry, they both miss the essential point. The essential point is this: *how*, and *why*, were the agencies able to transgress so destructively? Endeavouring to understand the nature and the causes of their transgressions is surely essential if we are to properly explain what went wrong, or to offer *plausible* suggestions for better regulating the agencies in the future. This thesis, therefore, endeavours to identify, in detail, the forms of misconduct engaged in by the agencies, and the causes – including the systemic causes – of such misconduct. It is then able to begin the task of

[1] Department of Justice 'Justice Department and State Partners Secure \$1.375 Billion Settlement with S&P for Defrauding Investors in the Lead Up to the Financial Crisis' [2015] Department of Justice: Office of Public Affairs (Feb. 3).

devising regulatory reforms that address, very directly and specifically, the empirical nature of the industry's failings, and the identified causes thereof. There must be a logical correspondence between *how* the agencies misbehaved, and *how* we might stop them doing so again; my thesis aims to achieve that. It is important to note however that the nature of the misconduct is complex and its causes are multiple, yet, and to foreshadow my argument a little, I suggest that one key component in explaining the agencies' misbehaviour includes the fact that the largest agencies established non-essential ancillary service divisions in the lead-up to the crisis. Their doing so, and the levels of income such services generated, almost entirely nullified, and continues to do so, any 'consequence' that may be derived from the fines that are being predominantly used by the State to discipline the industry.

As a result, the credit rating agencies have been left to proceed in a manner that is a genuine threat to the public interest. The notion of 'public interest' will be dissected throughout section 2.2 *The Desired Situation*, but for this thesis the aim is to *protect* the public and make large scale social damage a thing of the past; it is simply not an acceptable part of life that the misdemeanours of financial actors should have such a devastating impact upon the lives of citizens. The reverence attached to the 'historic fine' means that for the authorities *their work is now done* with regards to disciplining Standard & Poor's. However, the profits garnered by their ancillary service division, S&P Capital IQ, means that a division that has no bearing on the accuracy of their credit ratings has protected the income from their bottom-line; this is simply not a deterrent against future transgressions.

So, the protective capacity afforded to the agencies via their ancillary service divisions is the target for this thesis' reform proposal. This is primarily because whilst other proposals may be more gratifying, i.e., heavier fines or prison sentences for offenders, this thesis is operating on the basis that only small and incremental proposals are *practicable*. We shall see the reasons for this understanding, because throughout the thesis there is evidence that suggests that the rating industry is extraordinarily embedded, resourceful, and protected. Therefore, the thesis will ultimately be defined by its reform proposal: the absolute and irreversible abolition of additional service provision within the credit rating industry, with ‘additional services’ meaning everything other than rating services.

In order to understand why this proposal is optimal, the thesis will embark upon an analysis that will describe who the agencies are and why they are deemed to be important. Having done this it will then be advanced that the agencies actually operate in a different manner than what they *ought* to, which results in the conclusion that any reform proposals, or indeed any analysis of the ratings industry, must be focussed predominantly upon what they *actually* do, rather than what we may *desire* them to do; any use of the *desired* version of events in analyses should only be used to gauge the severity of the agencies’ transgressions. We shall see examples of when the *actualities* of the rating industry have not been considered enough by legislators and regulators, which has led consistently to inefficiencies that have been exploited by the rating agencies. For this thesis the most important aim is to curb this exploitation, and reducing their capability to absorb the only discipline deemed appropriate is a workable way of doing so.

In order to reach this goal of establishing a reform proposal that would see the agencies’ capability to absorb financial penalties reduced, the thesis must answer a number of important questions. For the purposes of clarity, those questions are:

> **Research Question 1 -** What is the current role and status of the ratings industry, and why does that role require regulation?

> **Research Question 2** - What was the regulatory landscape that surrounded the ratings industry *prior* to the financial crisis?

Research Question 3 - What lessons can we learn about the effectiveness of that pre-crisis regulation?

Research Question 4 - What regulatory reforms were introduced as a response to the financial crisis, and what has been their effectiveness?

Research Question 5 - How does the provision of ancillary services support the agencies' ability to transgress, and what effect would the prohibition of ancillary service provision have upon that capacity?

The first task will be to answer the ***first research question*** and gain a thorough understanding of the target for this proposed reform, so to that end the first chapter will be a 'primer' for us, in that it describes in detail who the agencies are that make up the rating industry, their respective position within the industry, and also the ownership structures of the 'Big Three': Standard & Poor's; Moody's; and Fitch Ratings. Whilst this first chapter will be essentially descriptive, it will reveal for us the extraordinary position of the industry when we see that some of the world's most successful and influential figures have large stakes in these businesses; Warren Buffett's Berkshire Hathaway is the largest shareholder in Moody's, for example. The reason why this industry has attracted such influential figures to it is revealed when we assess the role of the rating industry. In examining its position within the socially-centralised financial markets, we will quickly realise that these agencies stand as the 'gatekeepers' to the capital markets, which naturally inserts their business into that of bond issuers, institutional and 'retail' investors, as well as the state; this entangled position has the potential to make incredible amounts of money and the biggest players in the market are more than aware of this.

This position within the socially-vital financial markets is the main reason the rating agencies need to be regulated, although that fact only dawned on legislators in the aftermath of the Enron scandal, which is an extremely important issue as we shall discuss later in Chapters 1, 2, and 3. We shall see in Chapter 2 more specifically however that the needs of each vital component within the marketplace – the issuer, the investor, and the state – means that efficient and impactful regulation is vital if any or all of these parties are to be prevented from being exploited by the agencies, or indeed from exploiting the agencies for their own benefit; each scenario leads to impressive short-term gains which are swiftly followed by rather incredible long-term societal losses as we saw in 2008 and beyond.

As this thesis is proposing reform that is built upon an alteration in regulatory attitude, namely that reform should be incremental yet impactful by focusing upon the *actualities* of the industry, it will be prudent to ask what the regulatory landscape that surrounded the ratings industry *prior* to the financial crisis was, in order to answer the ***second research question***. This will be achieved by the analysis in Chapter 1, which provides for us a 'snapshot' of the regulatory framework that has surrounded the industry since it was formally regulated in 2005/6 with the *Credit Rating Agency Duopoly Relief Act of 2005* and the *Credit Rating Agency Reform Act of 2006*. It is worth articulating now that for this thesis the focus will be on the regulatory framework adopted by the United States, primarily because the U.S. is the spiritual home of the rating agency as we know it today. Also, the centrality of U.S. financial products in the recent financial crisis means that any developments in regulation in this area are likely to be undertaken by the U.S. State. There will also be a discussion of this regulatory landscape in Chapter 4 because, as the aim is to look at what has been tried and what has failed, it will be important to provide an analysis of the entirety of the industry's relationship to regulators, which spans from the intervention of the Judiciary before the Great

Depression to the incorporation of credit ratings into the regulatory framework by the SEC in 1975.

In developing this line of enquiry, the thesis will answer the ***third research question***, which is what lessons can we learn about the effectiveness of that pre-crisis regulation? When we understand that the *Credit Rating Agency Duopoly Relief Act of 2005* and the *Credit Rating Agency Reform Act of 2006* were developed and enacted in response to the Enron Scandal (and perhaps the agencies' involvement with the Asian Financial Crisis of the late 1990s), we shall see that one of the biggest lessons we can learn with regards to regulatory effectiveness concerns cyclicity; the enactment of legislation five years after the fall of Enron (and WorldCom) meant that the legislative body was *reacting*, which meant it had no chance of limiting the damage that would come to light just a year later. Economic cyclicity is a major barrier for socially-impactful and beneficial financial regulation, as we shall see throughout the thesis.

This regulatory lag is unfortunately just one cause of the ineffectiveness displayed by pre-crisis regulations (the same may be said of post-crisis regulations). For this thesis one of, if not the main cause of this ineffectiveness is the focussing upon what one believes the agencies *ought* to do, or how the rating industry *ought* to be. Before the crisis this sentiment manifested itself in the form of absolute trust, which we now know was entirely misplaced. This trust was afforded to a number of core components of the modern economy, not just the rating industry, and revealed itself by way of mass deregulation which enabled the financial crisis to occur. We shall see a number of perspectives that argue this point, and some that argue against it, but irrespective of viewpoint the result was still the same.

The extraordinary transgressions of the leading rating agencies, along with other vital components of the financial sector, resulted in the largest raft of legislative orders since the

‘New Deal’ era legislative directives incorporated in response to the Great Depression (and the Wall Street Crash of 1929). So, in light of this once-in-a-generation development, the thesis will answer the ***fourth research question***: what regulatory reforms were introduced as a response to the financial crisis, and what has been their effectiveness? To answer this question the thesis will provide succinct analyses of two important elements of credit rating reform: the Dodd-Frank Act of 2010’s reforms for the ratings industry as a whole, and then the specific reforms regarding the agencies’ provision of ancillary services.

In Chapter 4 we shall see that the Dodd-Frank Act’s aim at the financial sector was incredibly wide. Whilst that approach was obviously needed, the scale of reforms required was so large that certain concessions had to be made, and herein lies one of the major reasons for post-crisis regulatory ineffectiveness. We shall see that the post-crisis legislation fails on two counts, failures which have been subsequently confirmed by the continuation of the agencies’ transgressions even up to the present day. Firstly, legislators made the mistake of not amending the current regulatory system whereby legislators delegate a lot of responsibility to the regulatory bodies that will be in charge of administering the laws put in place by statute. Whilst the thesis does not offer a proposal on how to change that system, the current system of ruling that the agencies must act in a certain way but then allowing the SEC to develop the way in which this behaviour is to be achieved is a dangerous approach. We shall see that for a lot of people the SEC is central to the failings witnessed in the financial sector, so entrusting them with developing reforms is potentially paradoxical. Secondly, the legislators still focus upon the *desired* when developing their laws, which results in ineffectiveness. For example, we shall see in Chapter 3 that the rating industry is what is known as a ‘natural oligopoly’, in that competition is extremely limited and benefit can only be derived by those who deal with the agencies *because* of the lack of competition i.e. costs for the issuers are kept to a certain level because investors only require a maximum of 2 ratings to invest in an issuance. Yet, the post-crisis legislations make the idea of increasing competition in the ratings industry *central* to their approach, which is indicative of this misplaced focus that this thesis is attempting to correct.

This ineffectiveness has the result of continuing to allow the rating agencies to transgress, which they are doing. This has been confirmed by a continuous stream of investigative reporting and court actions against the agencies being initiated *around the globe* regarding the transgressions of the agencies. There are a number of reasons why the agencies *can* transgress, and those will be covered in Chapter 3 when we look at why the agencies transgress and what allows them to do so. However, the final two chapters of the thesis will be devoted to answering the ***fifth and final research question***: How does the provision of ancillary services support the agencies' ability to transgress, and what effect would the prohibition of ancillary service provision have upon that capacity? The reason why the provision of ancillary services has been selected for reform by this thesis is for one simple reason; out of all the issues it is perhaps the simplest to amend. The remuneration model adopted by the agencies, whilst conflicted, does allow for the continued provision of credit ratings that are important for the capital markets whereas without it the service could not continue at the required levels (arguably). The lack of competition is arguably understandable when we assess the *actual* requirements of interested parties; lowering costs for investors will always trump increased transparency that would come from the increase in reputational pressure, by way of increased competition. However, the provision of ancillary services simply does not affect the accuracy of credit ratings, nor does it increase the transparency of the rating process. To remove the issuer-pays remuneration model, of which more will be discussed throughout the thesis, would surely take the agencies out of business, as would the manufacturing of competition; there are no such dramatic effects with the proposed removal of ancillary services.

In Chapter 5 we shall see the real issue with the provision of ancillary services. This thesis opened with a statement taken from the DoJ that was announcing the *record* fine of $1.375 billion given to S&P, a fine which would come to represent the height of the discipline that is to be afforded to the rating industry (at the time of writing Moody's still awaits it fate). Yet, these non-essential ancillary service divisions, that the leading agencies incorporated in preparation of their involvement with the securitisation debacle that was at the centre of the financial crisis, now contribute over $1 billion in revenue *annually* to S&P and to Moody's, and have done for a number of years. We shall see in Chapter 5 that the economic term for this is 'rent-harvesting', in that the agencies are taking advantage of their embedded position to garner as much money as they possibly can. This 'harvesting' measure is actively acting to offset the effect of such 'record' disciplinary measures, and this is unacceptable for this thesis when we take into account the non-essential nature of the provision.

So, in Chapter 6 the thesis concludes by offering its reform proposal; the absolute and irreversible abolition of additional service provision by credit rating agencies. The reform is detailed in a way that the lessons of the ineffective legislation incorporated both before and after the crisis are taken into account. The reform is purposefully unambiguous and provides clear reasons for the measures it proposes. In order to increase the potential impact of the reform proposal, the last chapter includes historical precedent for such levels of state intervention in the financial sector, looking at the banking sector in the 1930s and the public accounting sector in the early 2000s. It also includes two very forthright sections that attempt to anticipate the potential benefits of the reform being enacted, as well as the potential impediments to it being considered.

The overarching aim of this thesis is to present a reform proposal that has the capability of aligning the output of the rating agencies closer to the 'public interest'. This notion of there being a definable 'public interest' is a particularly charged one, and is something that will be discussed in much greater detail in section 2.2.4 *'Public Interest' or 'Public Protection'?*. However, to attempt to realign the output of the ratings industry requires much more than a reform proposal, and this thesis endeavours to answer that call by providing detailed analyses of the components of the industry, in addition to the demonstration of there being a divergence between what people may *desire* of the agencies and what they *actually* do. In combining all of these elements the thesis aims to cast a new light upon an industry that directly facilitated one of the largest financial crashes, and threats to society, that the world has ever witnessed.

0.1 Research Methodology

Whilst there are many variants of research that a project may be classified as, for our understanding it would be helpful to start with two seemingly central variants: normative research and descriptive (or empirical) research[2]. Broadly speaking, descriptive research aims to describe what is happening, how it is happening, and then what is expected to happen in the future, based upon the *evidence* gathered by what was revealed in the earlier parts of the examination, whereas normative research aims to provide guidelines for decision making, in outlining what 'a rational decision maker should do under the identified conditions in order to attain a given objective'[3]. This thesis falls more closely to that of the *normative* mode of research, although as we shall now discuss there are important aspects to consider and question, with the most important being that to attach oneself, or a project, to just one approach is disadvantageous, as Halperin and Heath suggest: '…theory and evidence inform

[2] John Kuada *Research Methodology: A Project Guide for University Students* (Samfunds Litteratur 2012) 42.
[3] ibid.

each other. Seeing either one as entirely divorced from the other generates either fantasy or mindless empiricism'[4].

This discussion of a multi-levelled analysis is a very important one. However, such a multi-levelled approach needs to be considered and critiqued constantly if it is to be effective, because as Bauböck notes the two branches can assist each other, although this is not always well done. Bauböck argues that empirical researchers too often resort to 'ad hoc' normative assumptions and normative researchers often rely on hypothetical arguments in spite of available empirical evidence, whilst others may interpret empirical research naively without the necessary critical knowledge[5]. There are also major issues in prioritising one method over another, and crucially in attributing values to a system without critically assessing it first. With regards to normative research, it has been said that a researcher cannot 'prove that a given value has absolute validity'[6], so inevitably the foundation of normative research is inherently subjective. Alternatively, for empirical research, the trust in 'knowledge' is perhaps its biggest weakness in that it is arguably naive to accept certain aspects as 'facts' without critically analysing what underlies the production of those 'facts', or the methods used in collating such information, with statistics being a classic example; the most famous work in this regard is arguably Michel Foucault's *The Archaeology of Knowledge*[7].

Onlookers have noted that the push to rid science of 'values', by reducing them to 'emotive expressions'[8], has not succeeded but has left normative thinking 'to wither in many parts of social science', which has marginalised normative discourse, weakened our ability to do it,

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[4] Sandra Halperin and Oliver Heath *Political Research: Methods and Practical Skills* (OUP 2012) 5.
[5] Rainer Bauböck 'Normative political theory and empirical research' in Donatella D Porta and Michael Keating *Approaches and Methodologies in the Social Sciences: A Pluralist Perspective* (CUP 2008) 40.
[6] Ludvig Beckman *The Liberal State and the Politics of Virtue* (Transaction Publishers 2000) 11.
[7] Michel Foucault *The Archaeology of Knowledge* (Routledge 1972). For the original version see Michel Foucault *L'archeologie du savior* (Ėditions Gallimard 1969).
[8] Andrew Sayer *Realism and Social Science* (SAGE 2000) 157.

and in turn has reduced the incentive to adopt the approach in future[9]. This is a particularly negative development within the realm of research because to attribute superiority to one mode of research over another fundamentally limits our opportunity to affect real change.

As will be discussed in more detail later in section 2.2.4 *'Public Interest' or 'Public Protection'?*, this thesis aims to align the output of the rating agencies closer to the 'public interest', by which the thesis really means 'public protection' in terms of the reduction of societal ills like homelessness, poverty, suicides, and disease[10]. However, whilst one may assume that this ideal is shared throughout society, one cannot state that this is definitely the case (universally speaking) and this has to be considered as an underlying critique of this thesis, as Beckman suggests should always be the case with both normative and empirical studies – 'in neither case does the researcher have clear or unmediated access to reality as it is'[11]. This notion, along with the fact that normative research will be usually designated as being more controversial than empirical research, therefore has to be acknowledged. However, that does not mean that the results of this thesis' endeavours should be any less valid than those conducted by an empirical researcher, because even though as a society we tend to accept empirical findings as 'true' before we accept normative findings that are concerned with moral stances as being similarly 'true', the fact that it is usually harder to develop a consensus on what can be taken for granted in a normative analysis should not affect the validity of the project, as Beckman states: '…the degree to which conclusions are controversial does not necessarily depend on the degree to which they are valid. A normative conclusion can be valid in the sense that it follows from the assumptions made initially even when it is controversial. Quite frequently, this is the case with empirical conclusions too'[12].

[9] ibid.
[10] See 2.2.4 *'Public Interest' or 'Public Protection'?* (fn 59).
[11] Beckman (n 6) 12.
[12] ibid.

On the face of it the thesis appears to be an amalgamation of 'critical social research' and a typically normative endeavour. Stubbs describes that critical social research 'seeks to establish what underlies the surface appearance of a phenomenon, to reveal the oppressive nature of social relations and to inform social change'[13]. As this thesis begins with a descriptive approach to introduce a foundational understanding of the credit rating industry, and then delves into the differentiation between the *desired* and the *actual* to understand what the reality of the rating industry and its relationship to interested parties actually is, it seems as if it clearly fits into the classification of 'critical social research'. However, there are two issues that make this designation somewhat inappropriate. Normative endeavours are usually defined by what they establish as what *ought* to be, which then may or may not provide for controversy or debate. But, this thesis does not fabricate this idealised vision of what *ought* to be. What the thesis is calling for is precisely what is marketed by the rating agencies themselves. It is not this thesis, but the rating agencies who declare that their role is to make financial markets 'operate more efficiently and transparently'[14], yet there is evidence of a concerted campaign by leading agencies, as we shall see throughout this thesis, to do exactly the opposite of this 'role' that they fulfil. In essence, what the agencies *ought* to do is exactly what they say they do; this should not be controversial at all.

The second reason why this thesis is difficult to classify in terms of research approach is because this thesis is ultimately concerned with a much broader issue than either normative or empirical research usually aims for. Perhaps the most fitting label for this approach is articulated by Max Weber when he describes the concept of *Gesinnungsethik*[15]. This concept

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[13] Julie Stubbs 'Critical Criminological Research' in Thalia Anthony and Chris Cunneen *The Critical Criminology Companion* (Hawkins Press 2008) 12.
[14] Moody's *Our Role* (2015).
[15] For the discussion on Max Weber's development of the concept, and the many issues that surround that, see Richard Swedberg and Ola Agevall *The Max Weber Dictionary: Key Words and Central Concepts* (Stanford University Press 2005) 90.

is supposed to signify *purity of intention* heedless of actual outcome[16], although the many issues that come with this notion make attaching oneself to it particularly hazardous. The issue that arises again and again is that the simple intention of this thesis does not fall into any one category, so the only solution to that is to be as explicit as possible and move forward accordingly, even in the face of potential disregard for its simplicity. *This thesis simply calls for the reduction of social harm that result from fraudulent and misrepresented practices within the financial sector*. This simple aim will be achieved by describing the rating industry, examining its *actual* conduct in opposition to its *desired* conduct (of which a lot stems from its self-stated conduct), and then proposing a measure which would reduce the ability of the agencies to protect themselves against financial discipline. There are a number of aspects which will need to be considered along the way, but throughout the analysis that follows this simple aim must be remembered; it is this simplicity that can allow for meaningful change to be realised so that the horrific consequences of greed and excessive self-interest can be condemned to history.

[16] Alan Gilbert *Democratic Individuality* (CUP 1990) 426.

Chapter 1 - A Primer on the Credit Rating Domain

1.1 Introduction

In essence, the primary role of the rating agencies is to assist a range of investors in making informed investment decisions[1]. In theory, the expert research and analysis conducted by the agencies protects investors from 'unknowingly taking credit risk'[2]. However, the vast losses incurred throughout the Financial Crisis, particularly those involving investments in highly rated financial products[3], means that to assess the reality of the rating industry's role is a particularly worthwhile endeavour.

This chapter therefore represents a primer on the credit rating industry. Its aim is to provide a sound foundational understanding of what a credit rating agency is; its role within the economy; and the regulation that seeks to control the ratings industry. The incredible effect that the ratings agencies have[4] means that if we are to analyse the intricacies of this unique industry effectively, then this elementary assessment will be extremely important. To do this

[1] Neil D Baron 'The Role of Rating Agencies in the Securitisation Process' in Leon T Kendall and Michael J Fishman *A Primer on Securitisation* (MIT Press 2000) 81.
[2] ibid.
[3] The Financial Crisis, triggered by the collapse of Lehman Brothers in 2008, encapsulated the essence of a collapsed economy, including financial sectors like financial services, automobiles, and even states and countries. For an informative overview of one of the largest collapses on record see Financial Crisis Inquiry Commission *Financial Crisis Inquiry Report* (GPO 2011). In the report (xxv), the Commission made it very clear that the Crisis simply could not have taken place without the facilitation of the rating agencies: 'We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction'. With regards to the losses experienced as a result of the Crisis more generally, finding even an approximate figure is extremely difficult, probably due to the fact that the effects of the Crisis are still continuing to unfold, and that collecting and comparing global data is notoriously difficult in itself. Just some attempts to approximate the damage include: the U.S. Treasury, that in 2012 estimated the 'lost household wealth' in the US alone to be $19.2 trillion, see The United States Department of the Treasury *The Financial Crisis Response: In Charts* (2012); a former S&P Chief Credit Officer estimating global losses to be in the region of $15 trillion, see Al Yoon 'Total Global Losses from Financial Crisis: $15 Trillion' [2012] Wall Street Journal (Oct. 1); and the Government Accountability Office that estimated the losses to be in the region of $22 trillion, comprising the lost output ($13 trillion) and the paper wealth lost by U.S. homeowners ($9.1 trillion), see United States Government Accountability Office *Financial Regulatory Reform: Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act* (GAO 2013).
[4] Charles F Adams, Donald J Mathieson, Garry Schinasi *International Capital Markets: Developments, Prospects, and Key Policy Issues* (International Monetary Fund 1999) 101 'credit rating agencies have been viewed by many market participants as having a strong impact on both the cost of funding and the willingness of major institutional investors to hold certain types of securities'. For further analysis on the role of the agencies in the marketplace see Dieter Kerwer 'Standardising as Governance: The Case of Credit Rating Agencies' in Adrienne Windhoff-Héritier *Common Goods: Reinventing European and International Governance* (Rowman & Littlefield 2002).

the chapter will primarily ask three questions: who are the credit rating agencies? What is it that they do (including, what is their role within the economy)? And finally what is the regulatory framework that governs them?

Throughout the thesis there will be constant references to 'the credit rating agencies' or the 'ratings industry', but those blanket terms conceal dynamics within the ratings industry that are very important to understand. For example, an analysis of the global market share and ratings distribution (i.e. ratings produced) within the ratings industry reveal an extraordinary concentration of power among three agencies; Standard & Poor's, Moody's, and Fitch Ratings. Analysing these industry dynamics will be very important if we are to answer the second the question that the chapter will ask, namely 'what do rating agencies do and what is their role within the economy?'

We have already seen that the stated aim for the ratings industry is to 'assist a range of investors in making informed decisions'. However, this is not the only role of this large industry. In answering the second question of what it is that the agencies do and what their role within the economy is, the chapter assesses who actually uses the output of the industry, and for what purposes. Although there is a lot of discussion to be had regarding the role of the industry, the validity of their position, and many other aspects, what is not debatable is their current significance to the fluidity of the capital markets. With the capital markets being the foundation of the modern economy, the usage of credit ratings by large institutional investors, banks, and other large financial entities means that understanding the industry's role will be an important but complex affair.

The complexity of the role means that the task of regulating the industry is extraordinarily difficult. It is for this reason that answering the third question posed by this chapter, namely what is the regulatory framework that governs them, ultimately means that we can build our knowledge of the capabilities and limitations of actually regulating the credit rating industry. The incredible amount of analysis of the failings surrounding the Ratings Industry and their role in the Financial Crisis perhaps points to the conclusion that regulators have failed in overcoming such a difficult task. However, in order to assess whether such an understanding is correct it will be very important to provide a basic understanding of the regulatory framework that governs the industry and its exploits. The regulation of the ratings industry in the United States is primarily a statutory endeavour, with the Judiciary and Department of Justice being mostly concerned with elements of fraudulent or criminal behaviour[5]. As we shall see, infringements of economically concerned legislation (The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[6], hereafter the 'Dodd-Frank Act', for example) are punished by fines from the Securities and Exchange Commission (SEC) predominantly, although the SEC does theoretically have other powers at their disposal. In establishing and understanding this regulatory environment within which the ratings industry operates, we will be better able to understand any perceived or potential deficiencies in the regulatory approach to the conduct of the ratings agencies.

1.2 The Industry: Who They Are

In terms of the global market for credit ratings, there are two important aspects. Firstly, the global ratings industry contains over 100 rating agencies, with the vast majority being

[5] The Department of Justice recently entered the regulatory picture when it found Standard & Poor's guilty of fraudulent behaviour during the Financial Crisis and beyond, ultimately prohibiting the agency from conducting certain business and fining it a record $1.375 billion for losses suffered by federally insured institutions. For more see Aruna Viswanatha and Karen Freifeld 'S&P reaches $1.375 billion deal with U.S. states over crisis-era ratings' [2015] Reuters (Feb.3).

[6] 124 Stat. 1376.

concerned with local economies or specialised fields[7]. Secondly, this vast market is dominated by only three agencies, with Moody's, Standard & Poor's, and Fitch controlling over 90 percent of the market between them[8]. This dominance of the market has been recognised as being a *de facto* oligopoly[9], although closer analysis of the precise market share and dynamics of the financial markets hints at the existence of 'a partner monopoly' between Moody's and Standard & Poor's[10], or to be less cynical a cross between a duopoly and an oligopoly[11].

Moody's Corporation is the parent company of two legally separate operating divisions: Moody's Investors Service and Moody's Analytics[12]. Moody's Investors Service (MIS) 'provides credit ratings and research covering debt instruments and securities', whereas Moody's Analytics (MA) 'offers leading-edge software, advisory services and research for credit and economic analysis and financial risk management'[13]. These services which Moody's Analytics offers are classified for regulatory purposes as 'Ancillary Services' and are defined by Moody's as 'products and services that are not Credit Rating Services, and

[7] House of Lords: European Union Committee *Sovereign Credit Ratings: Shooting the Messenger?* (The Stationery Office 2011) 24.
[8] ibid; European Securities and Markets Authority 'Credit Rating Agencies 2014 Market Share Calculations for the Purposes of Article 8d of the CRA Regulation' [2014] ESMA/2014/1583; Gianluca Mattarocci *The Independence of Credit Rating Agencies: How Business Models and Regulators Interact* (Academic Press 2014) 121.
[9] House of Lords (n 7); Raquel G Alcubilla and Javier R del Pozo *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (OUP 2012) 6.
[10] There is evidence to suggest this arrangement exists, in that the ratings actions of the leading two agencies have an enormous impact upon Fitch's ratings, but not vice-versa. In addition, it has been noted that Moody's tend to follow S&P's negative watch/outlook opinions, whilst S&P tend to follow Moody's positive outlook/watch signals, hinting at a partner-monopoly, see Rasha Alsakka and Owain A Gwilym 'Rating Agencies' Credit Signals: An Analysis of Sovereign Watch and Outlook' [2012] 21 International Review of Financial Analysis 46.
[11] Representative estimates place S&P's market share at between 39 and 42 percent, whilst Moody's is between 34.5 and 37 percent (accounting for variations between American and European estimates). Fitch is represented at between 16 and 18 percent, lending credence to the argument of Fitch that 'currently the industry [is] a "duopoly" since S&P and Moody's "are virtually omnipresent in the investment guidelines of investors"'. See House of Lords (n 7) 24; European Securities and Markets Authority (n 8); Robert J Rhee 'On Duopoly and Compensation Games in the Credit Rating Industry' [2013] 108 Northwestern University Law Review 89 93.
[12] Autorité des Marchés Financiers *AMF 2009 Report on Rating Agencies* (AMF 2010) 36. As a result of being a wholly-owned public company, Moody's are legally required to submit annual financial reports. It is for this reason that Moody's will be the primary focus of this thesis, although their figures have been recognised as being representative of S&P's position also.
[13] Moody's *About Moody's* (2015).

which are market forecasts, estimates of economic trends, pricing analysis, or other general data analysis, as well as related distribution services'[14], though it is worth noting in addition to Moody's' self-definition that MA is also the division that controls the sales and marketing efforts for the corporation as a whole[15]. Regulation in light of the recent financial crisis has ruled that the activities of the rating and ancillary entities of the ratings agencies that offer such services must be kept separated[16].

Moody's is a particularly vast financial entity in its own right. Its total revenue for the financial year of 2014 was $3.33 billion, with an operating margin 43.2 percent[17], which commentators have been keen to note is much higher than a host of more recognisable entities like Google, Microsoft, or ExxonMobil[18]. MIS rates approximately 130 sovereign nations, 11,000 corporate issuers, 21,000 public finance issuers and roughly 76,000 structured finance obligations. In order to do this, the firm employs nearly 10,000 people worldwide and has a presence in 33 countries[19]. Organisationally, legendary investor Warren Buffett's Berkshire Hathaway is the majority shareholder with the influential Vanguard Group also holding significant shares in the company, perhaps signifying the incredible investment opportunity that Moody's represents.

Standard & Poor's is equally as impressive, if not more so[20]. However, whilst Moody's is a stand-alone public corporation, Standard & Poor's is not. S&P represents just part of the activities of the US-based group McGraw-Hill, which also contains other businesses in the

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[14] Moody's *Policy for Ancillary and Other Permissible Services: Compliance* (Moody's 2012).
[15] Autorité des Marchés (n 12).
[16] This aspect of the regulatory framework forms the raison d'être for this thesis, so the regulatory requirements concerning the said separation will be covered in much greater detail in following chapters (5 and 6 predominantly). For information on Moody's regulatory disclosures concerning this separation see Moody's *MIS-MA Separation Policy* (Moody's 2011).
[17] Moody's *Annual Report 2014* (Moody's 2015) 2.
[18] Ross Levine 'The Governance of Financial Regulation: Reform Lessons from the Recent Crisis' [2012] 12 International Review of Finance 1 45.
[19] Moody's (n 13).
[20] S&P have approximately 1.2 million credit ratings outstanding, rated $4.3 trillion in new debt in 2014 alone, and employs nearly 1,400 people across 26 countries, see Standard & Poor's *Who We Are* (2015).

field of publishing and education[21]. Standard & Poor's, though at one time just a division of the parent company, was transformed in 2009 into a wholly-owned subsidiary and contributes over $3 billion to McGraw-Hill's total revenue, providing for 44 percent of McGraw-Hill's total[22].

Standard & Poor's also contains a division that supplies Ancillary Services to the market, with their offering being called S&P Capital IQ[23], which in a similar vein to their counterparts at Moody's Analytics offers 'the highest quality financial intelligence covering both public and private capital markets'[24]. Standard & Poor's must also disclose under regulatory rules the pre-emptive actions taken to ensure the separation of rating and commercial entities[25].

The third component of the oligopoly that dominates the rating industry is Fitch Ratings. An amalgamation of a number of rating agencies[26], Fitch Ratings, as part of the Fitch Group, is majority-owned by the influential Hearst Corporation, having increased its equity share at the expense of the previous majority holder, French conglomerate Fimalac, in 2014[27]. Fitch also has its own designated ancillary service provider in Fitch Solutions, which like the comparable divisions at Standard & Poor's and Moody's requires separation from the commercial entities contained within the group as a whole[28]. Owing to its status as a subsidiary of both the Hearst Corporation and Fimalac, gaining any sense of the scope of the Fitch Group is particularly difficult, although Fimalac report that in 2013 the Group

[21] Autorité des Marchés (n 12) 37.
[22] ibid 38.
[23] Standard & Poor's (n 20).
[24] S&P Capital IQ *Information You Need* (2015).
[25] Standard & Poor's *Confidentiality, Conflicts and Firewall: Policy Statement* (Standard & Poor's 2012).
[26] Autorité des Marchés (n 12) 38 The Fitch Group merged with the UK agency IBCA, a bank rating specialist, in 1997. It then acquired the fourth-largest US rating agency, Duff & Phelps, and the Canadian bank rating specialist Thomson BankWatch in 2000.
[27] See Fimalac *Strategic Focus* (2015); Hearst Corporation *Hearst Corporation to Increase Equity Interest in Fitch Group to 80 Percent* (2014).
[28] Fitch Ratings *2015 Form NRSRO Annual Certification: Policies and Procedures Adopted and Implemented to Prevent the Misuse of Material, Non-Public Information* (Fitch Ratings 2015).

generated revenues of $982 million[29], which in itself clearly demonstrates the disparity between Fitch and the two leading agencies in the field.

As the large financial entities that dominate the capital markets are often required by regulation to utilise the ratings of rating agencies, it should come as no surprise that 'The Big Three' are all registered to both the SEC and the European Securities and Markets Authority (ESMA). It should come as no surprise because it is perhaps reasonable to assume that the state would want to formally oversee the entities that it is forcing upon large and influential market actors, although as we shall see in Section 1.3 *A Snapshot of the Regulatory Framework* this formal registration only took place from 2006 onwards. Apart from the Big Three, there are a few other registered agencies that may be worth mentioning, although it must be noted that the reason for their inclusion into this analysis is to fulfil the aims of providing a thorough primer of the industry; their combined market share actually makes them rather insignificant when compared to the actions of the Big Three. A.M. Best Company, for example, is recognised as being the fourth rating agency, although its specialisation in the insurance industry means that it is not in the same category as the agencies above it. As an issuer of 'fixed-instrument debt ratings that cover bonds, notes, securitisation products and other financial instruments issued by insurers and reinsurers[30]', it does have its place within the financial landscape (although the Big Three all conduct more business in the Insurance field than A.M. Best do). It is perhaps worth noting that A.M. Best do not offer Ancillary Services in the same manner as the Big Three, though they do employ

[29] Fimalac *Fitch Ratings* (2015)
[30] A.M. Best *About* (2015).

the infamous Issuer-Pays revenue model[31]. On the contrary, Egan-Jones Rating Company, a smaller firm still, actively maintains the investor-pays model, an aspect that the company has incorporated heavily into its sales pitches in order to define itself from other rating agencies. Having started producing ratings in 1995, it is also noted for flagging the failures of Enron and WorldCom at an earlier stage than any other agency[32]. Other noted registered agencies include Dominion Bond Rating Service (DBRS), the Canadian-based agency recently acquired by the influential Carlyle Group[33], and Morningstar Rating, which is heavily involved in Investment Advice and Management[34].

There are of course a number of agencies that are predominantly concerned with the countries from which they hail[35]. However, one cannot fail to notice the dominance of the US based agencies in the analysis above. One scholar suggests that the agencies' knowledge 'has a special salience to it because knowledge emerging from the United States has a higher global

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[31] The Issuer-Pays model is the revenue model adopted by the Big Three in the 1970s, as opposed to the subscriber-pays model that was in effect up unto that point. The Issuer-Pays model denotes the system where the issuer of debt will contract and remunerate the agency to formulate a rating; the subscriber-pays model is paid for by individual subscribers to the reports of the rating agencies, which contain ratings, as well as reports and in-depth analysis of rating decisions. The Issuer-Pays model has a number of advantages and disadvantages; on the positive side it helps issuers to have more involvement in the process and disclose more beneficial information for all parties, whilst it also allows for the widespread dissemination of ratings information for no cost to investors which, in turn, allows the agencies to channel more resources into their operations and should, in theory, increase the accuracy of their reports. However, there are negatives which are impossible to ignore. Irrespective of any mechanisms the agencies may employ, they simply cannot guarantee insulation from the numerous conflicts of interest that are inherent within a relationship where you are paid by the people you are assessing. Ratings influence (whether perceived or actual), ratings shopping (issuers purchasing ratings from only agencies that provide favourable ratings), and a number of other elements that will be discussed throughout are aspects that are prominent in a large number of people's criticisms of the industry. For just some analysis on the dynamics of the revenue model see Deryn Darcy 'Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" conflict contributed and what regulators might do about it' [2009] Columbia Business Law Review 2; Douglas D Evanoff *The First Credit Market Turmoil of the 21st Century* (World Scientific 2009); Martha Poon 'Rating Agencies' in Karin K Cetina and Alex Preda *The Oxford Handbook of the Sociology of Finance* (OUP 2012).
[32] Egan-Jones Rating Company (2015).
[33] Dominion Bond Rating Service *About* (2015).
[34] Morningstar Rating (2015).
[35] Agencies that fit this definition include the Japan Credit Rating Agency, H.R. Ratings de México, S.A. de C.V., Feri EuroRating Services AG, CERVED Group S.p.A., and Axesor SA.

valuation than that produced by a British, Canadian, or Japanese agency'[36], which may provide some analytical reasoning behind the unmistakeable dominance of the Big Three. Nevertheless, now we know who the major components of this extraordinarily lucrative industry are, it is appropriate to ask the question 'what is it that they do?'

1.3 The Industry: What It Does

This section aims to provide a first overview of the role of the rating agencies within the economy. The aim is to be primarily descriptive, so as to provide a reader who may be relatively ignorant of the role performed by the industry insight into its essential functions. Chapter 2 *A Distorted Reality* will continue this endeavour, albeit in much more detail; the chapter will have a greater emphasis upon providing a critical evaluation of the actual practices of the industry, and also on the potential disparity that exists between the idealised role of the industry and the actual deliverance of the rating service.

A basic understanding of what the rating agencies do would be achieved by the understanding that 'a credit rating is an opinion provided by a rating agency for a fee on the credit risk or creditworthiness of the bond issue, which reflects the probability of default of that bond'[37]. In order to be thorough however we must ascertain what lies at the core of the business of the agencies. What lies at the core of their business is the *bond*, which is a debt instrument issued by an 'issuer' that usually pays a fixed rate of interest over a fixed period of time[38], though

[36] Timothy J Sinclair 'Bond-Rating Agencies and Coordination in the Global Political Economy' in A. C. Cutler, Virginia Haufler, and Tony Porter *Private Authority and International Affairs* (SUNY Press 1999) 160. Naciri also notes this in addition to the fact that 71 percent of the Big Three's global revenues stem from the US, see Ahmed Naciri *Credit Rating Governance: Global Credit Gatekeepers* (Routledge 2015) 15.
[37] Rhee (n 11) 91.
[38] Moorad Choudry *Corporate Bonds and Structured Financial Products* (Butterworth-Heinemann 2004) 3.

this fixed nature of the instrument is not always the way the instrument is constructed[39]. There are four issuers of bonds: 'sovereign governments and their agencies, local government authorities, supranational bodies such as the World Bank, and corporations'[40], with the largest bond market being the government bond market by far.

Bonds usually have fixed interest rates, or *coupons*, that are paid to the investor by the bond's issuer on a semi- or annual basis. The *maturity* of the bond indicates the date when the debt ceases to exist, at which time the issuer must pay the *principal* and the last remaining interest payment to redeem the bond, thus completing the process[41]. This is the foundational understanding of an arena that is defined by its complexity.

This extraordinarily large system of finance[42] has a number of theoretical positives attached to it. Corporate issuers, or 'borrowers' as they may also be called, issue bonds to 'raise finance for major projects and also to cover on-going and operational expenses'[43], whilst sovereign entities use the issuance of bonds to alleviate the disparity between the expenditure requirements of the country against the income garnered from taxation, amongst other

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[39] For an foundational analysis of the bond and other structured finance instruments see Les Dlabay and James Burrow *Business* Finance (Cengage Learning 2007) 207; Moorad Choudry *An Introduction to Bond Markets* (John Wiley & Sons 2010); Sunil Parameswaran *Fundamentals of Financial Instruments: An Introduction to Stocks, Bonds, Foreign Exchange, and Derivatives* (John Wiley & Sons 2011) 10.
[40] Choudry (n 38) 3. It must be noted here that the agencies rate an issuer separately from the bond it issues. For example, in rating a bond the agency is only concerned with the issuer's ability to repay that particular debt (although they obviously take the health of the issuing firm more generally into account). Agencies therefore have issue-specific ratings and issuer-specific ratings which each have their own defining characteristics, see Stefan Trueck and Svetlozar T Rachev *Rating Based Modelling of Credit Risk: Theory and Application of Migration Matrices* (Academic Press 2009) 12; Scott McClesky *When Free Markets Fail: Saving the Market When It Can't Save Itself* (John Wiley & Sons 2010) 90; Giuliano Iannotta *Investment Banking: A Guide to Underwriting and Advisory Services* (Springer Science & Business Media 2010) 106; Thummuluri Siddaiah *Financial Services* (Pearson Education India 2011) 242.
[41] Choudry (n 38) 3; 4.
[42] Mark Mobius *Bonds: An Introduction to the Core Concepts* (John Wiley & Sons 2012) 1 'the worldwide value of all bonds outstanding was a record US$95 trillion in 2010, with about US$35 trillion in the US bond market'.
[43] Choudry (n 38) 5.

revenue streams[44]. For corporate issuers the advantages are plentiful. In addition to allowing for the raising of large amounts of resources for whatever requirement they may have, it also serves the company better than raising resources through the sale of stock[45]. Not only does the system benefit the issuer, but it also benefits the investor. The return potential of bonds is much lower than that of other investments like stocks. Yet, this is an attractive quality to the cautious investor who may take comfort from the relative security of a bond, whilst they may also use the bond to anchor their investment portfolio and use the interest payments on the bonds they hold to finance more speculative movements in the stock market[46].

These dynamics are the foundations for the modern ratings industry. The explosion of the capital markets in the 1970s meant that these dynamics would have to be integrated into the essence of the ratings industry, and their methodologies subsequently aligned to them. This is because in the wake of the collapse of Penn Central in 1970, both investors and issuers required a third-party who, through a perceived reputation-based level of independence,

[44] ibid. The rating of sovereign debt is proving to be particularly important with regard to the requirements of emerging markets that are now reliant upon access to the capital markets as opposed to the banking sector, see Constantin Mellios and Eric Paget-Blanc 'The Impact of Economic and Political Factors on Sovereign Credit Ratings' in Robert Kolb *Sovereign Debt: From Safety to Default* (John Wiley & Sons 2011) 325.

[45] Mobius notes that stockholders would theoretically much prefer a bond issuance to a stock sale, noting that the sale of shares would dilute the existing stockholder's equity position, and that the corporation would gain tax benefits from issuing bonds whereas they would not if they issued new stock, see Mobius (n 42) 7. The theoretical consideration behind this is called 'Capital Structure Theory' and is concerned with the positive and negative dynamics of the two different types of financing (bond and stock issuances), for more on the theory see Stephen Lumby and Chris Jones *Corporate Finance: Theory & Practice* (Cengage Learning EMEA 2003); Arvin Ghosh *Capital Structure and Firm Performance* (Transaction Publishers 2012). For more on the consideration of tax deductions being a factor in selecting a method of financing see Doron Peleg *Fundamental Models in Financial Theory* (MIT Press 2014). For further analysis on the aspect of management losing or maintaining control of the company and the methodology of obtaining finance being central to that dynamic see P C Tulsian and Vishal Pandey *Business Organisation and Management* (Pearson Education India 2002) 14-9; Theodore Grossman and John L Livingstone *The Portable MBS in Finance and Accounting* (John Wiley & Sons 2009) 147. Grossman and Livingstone also talk at length about what is considered to be the seminal work in this field written by Franco Modigliani and Merton H Miller 'The Cost of Capital, Corporation Finance and the Theory of Investment' [1958] 48 The American Economic Review 3. Modigliani and Miller asserted that the value of a firm stems from the 'cash-flow-generating ability' of its assets, rather than the way in which it is financed, although it must be noted that the model the two scholars use is an absolutely ideal scenario rather than a real-world consideration.

[46] Mobius (n 42) 8.

could signify to the marketplace the creditworthiness of firms and their debt offerings[47]. 'Informational asymmetry' is the term assigned to the informational gap that exists between investors and issuers, and represents the proclaimed justification for the existence and continuous usage of the agencies' services. Investors do not have the resources to perform credit risk analysis on each of the issuers they wish to invest in as a rule, and even the largest investors who do have adequate risk analysis divisions would find it ineffective to conduct such wide ranging analysis when a third-party exists to complement their own investigations[48]. Also, issuers are more inclined to share more information with a third-party assessor than they are with individual investors, in turn avoiding duplication costs in the gathering and analysis of information, which is of increasing importance given the ever-increasing complexities within the financial markets[49].

The agencies understand this and have developed their business accordingly:

> Through research, analysis, and information the nationally recognised credit rating agencies protect investors against unknowingly taking credit risk. Investment grade rating says something very specific. It says a particular instrument will pay interest and principle according to the terms of the indenture (contract). If you hold a twenty-five-year, triple-A bond to maturity, you are assured of getting 100 percent of the principal and interest on a timely basis[50].

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[47] Briefly, the collapse of the Penn Central Railroad company in 1970 triggered a systemic lack of trust in the creditworthiness of financial entities, meaning that a) investors needed independent assessments of a firm's creditworthiness and b) issuers needed a reputable and impartial party to vouch for their creditworthiness. This is the most common hypothesis for the upsurge in the industry's fortunes post-1970; for more on this see 3.3.1.1 *The Collapse of Penn Central Hypothesis.*
[48] Mattarocci (n 8) 1.
[49] Andrew Crockett *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?* (Centre for Economic Policy Research 2003) 42.
[50] Baron (n 1) 81.

Though this level of certainty is a disputable notion[51], it is theoretically correct that the inclusion of an investment-grade rating will *more-or-less* guarantee complete repayment, particularly with respect to corporate bonds[52]. The classification of what constitutes 'investment-grade' and 'non-investment-grade' (also known as 'speculative grade') is the same amongst the Big Three, with the investment-grade rating ranging from AAA (Aaa for Moody's) through to BBB- (Baa3 for Moody's)[53]. It is worth noting that a change in credit rating is by 'notch' rather than Alphabetical letter in the first instance. This is because agencies attach *notches* to their ratings to signify more precisely their assessment of a given entity or its offerings. The notches are either '+' or '-', or '1, 2, or 3' for Moody's (this is in addition to their market signifiers that signify to the market the sentiment of the agency towards the short-term future of the rating[54]). Whilst it would be tempting to attach a table to this thesis detailing each agency's ratings for us to compare, as some scholars have done, it is important that we understand that this would be hazardous for our assessment. It would be hazardous because each agency takes different aspects into account when developing their ratings. As well as differentiating their ratings based on short-term and long-term outlooks, the agencies also base their assessments on either default probability, or on the concept of

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[51] For a representative argument of the impossibility of guaranteeing certainty in this marketplace see Akos Rona-Tas and Stefanie Hiss 'The Art of Corporate and The Science of Consumer Credit Rating' in Michael Lounsbury and Paul M Hirsch *Markets on Trial: The Economic Sociology of the U.S. Financial Crisis, Part 1* (Emerald Group Publishing 2010) 117. Later in the thesis we will see how this notion of certainty is reputed by the industry in broader terms in order to limit the levels of liability it faces (see also Mattarocci [n 8] 2), and that the allure of the Triple-A rating only belongs to the corporate and sovereign issuance sectors in light of the dramatic failings of Triple-A rated securitised products in the Financial Crisis.

[52] Iain MacNeil 'Credit Rating Agencies: Regulation and Financial Stability' in Thomas Cottier, Rosa M Lastra, Christian Tietje, Lucia Satragno *The Rule of Law in Monetary Affairs* (CUP 2014) 180.

[53] Moody's *Rating Symbols and Definitions* (2015); Standard & Poor's *Standard & Poor's Ratings Definitions* (2014); Fitch Ratings *Definitions of Ratings and Other Forms of Opinion* (2014). Rhee notes in addition to this that these taxonomical divisions which include finer divisions are not opinions of the value of a bond, merely the estimation of likelihood of default and failure to meet interest and principal payment; the value of bonds can depend on a large number of intrinsic and extrinsic factors, see Rhee (n 11) 91; Adams et al (n 4) 102.

[54] See (n 80).

expected loss, which incorporates 'expected recovery in the event of default'[55]. In light of this, and although a unique definition of the 'rating service' has yet to be agreed upon, the declaration that 'a rating is a synthetic judgement that summarises, using an alphanumeric scale, the main qualitative and quantitative characteristics of an issue or issuer'[56] provides us with perhaps the simplest understanding of what the main service is that the agencies provide, at least providing us with something to build on.

Understanding the *role* of the industry is more important still. We have already discussed the vast scope and subsequent recompense of the ratings industry, factors that indicate that the opinions of an agency have a direct effect upon the global allocation of credit[57], which has the potential to impact the costs of an issuer dramatically. This in turn transfers the potential effect from the individual issuer to the marketplace as a whole, perhaps meaning that the opinions of the agencies are, in effect, macroeconomic factors[58], not just unrelated judgements.

This issue of 'judgement' is also an important factor to consider. The position of the agencies within the marketplace, between issuer and investor, has led people to conclude that the agencies are, in essence, auditors, similar to accountants or securities analysts. Pallante opines that the 'third-party' dynamic of the agencies' position is what relates the ratings

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55 Alcubilla and del Pozo (n 9) 59. See also John P Hunt 'Rating Agencies and Credit Insurance' in H K Baker and Gerald S Martin *Capital Structure and Corporate Financing Decisions: Theory, Evidence, and Practice* (John Wiley & Sons 2011) 300, who confirms that Moody's ratings reflect the expected loss, and S&P's reflect the risk of default. Hunt goes on to make the point that 'although the agencies do not assert that their ratings are comparable across agencies, regulations and users often treat ratings as comparable', a sentiment that draws explicit warning from Stebler who suggests that any results from a comparative study 'should be interpreted with due care', see Roman Stebler 'Performance and Consistency of Credit Ratings in Structured Finance' in Simone Westerfeld, Beatrix Wullschleger, and Pascal Gantenbein *Proceedings of the Second International Conference on Credit Analysis and Risk Management* (Cambridge Scholars Publishing 2014) 163.
56 Mattarocci (n 8) 2.
57 Naciri (n 36) 44.
58 Manfred Gartner, Bjorn Griesbach, Florian Jung 'PIGS or Lambs? The European Sovereign Debt Crisis and the Role of Rating Agencies' [2011] 17 International Advances in Economic Research 288.

industry to the industries of recognised auditors[59], although others have maintained that 'ratings are not audits of the entities being rated, nor are they designed to catch or prevent fraud'[60]. While this claim may be somewhat true, at least in the most rigid sense, it is somewhat 'disingenuous'[61]. It is perhaps disingenuous because, as Darbellay makes clear, the regulatory rules established by the Dodd-Frank Act 'result from the appreciation that CRAs play a fundamentally commercial role, thereby implying that they have to be subject to similar standards to other gatekeepers such as auditors and securities analysts'[62]. So, whilst they are not explicitly regarded as 'auditors' in the traditional sense, their positioning between issuers and investors has dictated that they are treated like an auditor.

This position between the two pillars of the modern economy - the issuer and the investor - is a fascinating one. The dynamic between them is precarious at times, and the services offered by the agencies help each party to protect and advance their position. Alcubilla and del Pozo note that there are three main aspects to the agencies' role with regards to issuers and investors. Firstly, they help mitigate the fundamental information asymmetry between the two parties. Secondly, the agency problem that is inherent within the modern economy can *potentially* be solved. With the largest investors being institutional investors (pensions funds, life insurers etc.), the ratings of the agencies can be used by the investors to dictate what investments the managers of the institutional investor (agent) can make on their behalf, which is one reason why most institutional investors are restricted to investing in AAA rated bonds and securities only[63]. Thirdly, the scholars suggest that the ratings can solve collective action problems in that the dispersed investors can use the ratings as a trigger for debt restructuring

[59] Tony Pallante *From Your Wallets to Their Pockets: Understanding the Credit Crisis: Privatising Profits and Socialising Losses* (iUniverse 2008) 108.
[60] LJ Rodriguez 'The Credit Rating Agencies: From Cartel Busters to Cartel Builders' in William A Niskanen *After Enron: Lessons for Public Policy* (Rowman & Littlefield 2007) 219.
[61] Jonathan R Macey *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2010) 114.
[62] Aline Darbellay *Regulating Credit Rating Agencies* (Edward Elgar 2013) 69.
[63] Rhee (n 11) 91.

without the administrative efforts that would be needed without the centralised views of the agencies[64].

The role the industry plays in the capital markets is important to understand, but can only really be understood when analysed in conjunction with how the market participants both use and view them. The investors, irrespective of their requirements (whether long- or short-term) use the ratings of the agencies as a common standardised benchmark to measure the credit risk of securities, whilst issuers request ratings only because investors use them. By paying the price for the ratings, issuers in turn lower their cost for placing their securities in the market place, by way of reducing interest rate payments[65]. Issuers also benefit from the arrangement by conveying to the market the effect of information that is confidential, via the authority of the intermediary (the rating agency)[66].

It has been noted that it may be useful to think of the issuers as the agencies' 'suppliers', whilst investors are their 'consumers'[67]. Because issuers rely upon the agencies to ensure the lowest rate of interest possible by way of a top-tier rating, issuers usually prefer to have more than one rating attached to their bond issuance, with there being examples of issuances containing three ratings in order to prove the creditworthiness to the market. Conversely, investors usually require fewer ratings, particularly institutional investors, as it has been argued that these sophisticated investors use the ratings as additional inputs into an already complicated risk analysis machine rather than the sole criteria for an investment decision. In this sense there is such a thing as too much information[68]. This notion of issuers being 'suppliers' has had an effect upon how they conduct their business. Crockett notes that issuing companies often structure their issuances in order to achieve a desired rating. They

[64] Alcubilla and del Pozo (n 9) 5.
[65] Alcubilla and del Pozo (n 9) 12.
[66] Mattarocci (n 8) 1; Crockett (n 49) 43.
[67] H K Baker and Sattar A Mansi 'Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors' [2002] 29 Journal of Business Finance & Accounting 9 1368.
[68] ibid 1395.

also create special-purpose entities that are specifically tailored for a designated investor who may have restrictions on what they can invest in, which in turn would reduce their borrowing costs[69].

While the processes of the agencies may seem to place the advantage with the issuer, the investor also uses ratings to their advantage, perhaps even more so than the issuer. The usage of 'rating triggers' are particularly useful for the investor when entering into contract with a borrower. These contractual provisions may include such aspects as the right to terminate the credit availability, accelerate credit obligations, or force the borrower to post collateral in the event of a rating change (downgrade)[70]. Though this has the potential to encourage a liquidity crisis on a vast scale, it nevertheless offers protection to the investor in a relationship where their resources are at stake.

1.3.1 The Rating Process

So far we have analysed the intricacies of the industry, in terms of what it does, its role within the marketplace, and how and why the two pillars of the capital markets use its services. Now though it is very important that we seek to understand the processes involved in the rating industry. Abrahams and Zhang remark that ratings 'should reflect an unconditional view and be forward looking and independent of the economic cycle. In other words, a wide range of future economic conditions should be factored into the credit rating process'[71]. How agencies

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[69] Crockett (n 49) 41.
[70] Alcubilla and del Pozo (n 9) 13. The scholars note that most triggers are relatively harmless for the issuer, with increased interest rates providing a common example.
[71] Clark R Abrahams and Mingyuan Zhang *Credit Risk Assessment: The New Lending System for Borrowers, Lenders, and Investors* (John Wiley & Sons 2009) 227.

go about performing this difficult task will help us to assess the justification of the agencies' position within the financial marketplace.

The rating process differs between the leading agencies. Some agencies may follow the process of analysts forming reports based upon qualitative and quantitative factors, which they then submit to a rating committee for final evaluations. Though most agencies have rating committees, some agencies tend to place more emphasis upon statistical modelling programs which results in a more mechanical process[72]. This reliance upon statistical modelling has been recognised as being central to the structured finance instrument rating process also[73]. We have already seen how the dynamics of the oligopoly are affected by disparities between the rating processes, with Standard & Poor's and Moody's being defined by their differing characteristics[74]. However, MacNeil argues that although there are clear differences in their approach to rating, there are three distinct similarities between the rating agencies. Firstly MacNeil asserts that the ratings are characterised by the agencies as 'an ordinal measure of credit risk rather than specific estimates of credit risk metrics such as default probability or expected loss'. He then argues that all three agencies distinguish between investment- and non-investment grade, which they do, and finally that rating stability is the primary objective of all of the CRAs[75], which in light of the Financial Crisis has become a point of debate.

Nevertheless, each agency does have its own procedure, but many aspects are indeed common. Firstly, the agency will have statistical models ready that contain algorithms that predict the statistical outcome of a given scenario, an example being what may happen to an

[72] Alcubilla and del Pozo (n 9) 18.
[73] Abrahams and Zhang (n 71)
[74] (n 10).
[75] MacNeil (n 52) 179.

airline if the price of oil rose to $100 per barrel[76]. When an issuer requests a rating for their issuance, an analyst (or perhaps more depending on a number of factors) is assigned to that issuance. Analysts usually concentrate on one or two industries only, which allows for an accumulation of specific expertise[77]. The analyst then uses their expertise and whatever methods they deem appropriate, which may involve liaising with the management of the issuer[78], to formulate a report that is to be presented to a convened rating committee. Rating committees vary according to the size and sensitivity of that particular rating.

The Rating Committee

The rating committee is championed as a vital part of the process. After the committee hears and debates the rating proposed to it by the analyst, it then casts a vote on what should be the final rating. This process is designed so that no one individual can have undue influence over the rating process. It is also championed as being the antidote to the issuer-pays conflict of interest, as agencies maintain that the committee has no revenue goal and therefore cannot be influenced by the will of the agency. However, McClesky rightly points out that it could be argued that although it is true that the analysts do not have specific revenue goals, their first- and/or second-level supervisors do, thus diminishing the desired effect[79]. Once the committee has come to an agreed rating, the issuer is given the option of appealing the decision based

[76] McClesky (n 40) 89.
[77] Trueck and Rachev (n 40) 14.
[78] ibid.
[79] McClesky (n 40) 90. It must be noted that there are procedures in effect to lessen this predicament, including reverse voting (junior analysts vote first so as not to be influenced by senior members), and all documents that assisted the committee in coming to a decision must be retained for SEC inspection. Ramirez also states that 'another former ratings agency employee stated that senior managers "intimidated" analysts and wanted employees who were "docile" and "afraid to upset the investment banks". Rating analysts often achieved higher bonus compensation based upon the performance of the ratings firm', see Steven A Ramirez *Lawless Capitalism: The Subprime Crisis and the Case for an Economic Rule of Law* (New York University Press 2014) 85.

upon the delivery of new information; the appeal process usually only spans a day or two[80]. After this period the rating is either released to the public or given to the issuer to release as an official corporate rating.

1.3.2 Signalling to the Market

Earlier we heard how the desired methodologies of the rating agencies would incorporate forward-thinking, cyclically immune considerations. The agencies attempt to meet this demand, though they also offer a different rating in order to cater for other investors. Although they represent the extremes of the rating methodological scale, both the point-in-time (PIT) system and through-the-cycle (TTC) system are important endpoints to consider. A good description of what these endpoints achieve for the investors is that a 'PIT-PD (Probability of Default) describes the actual creditworthiness within a certain time horizon, whereas TTC-PDs also take into account possible changes in the macro-economic conditions'[81]. It is rare however that an agency would rate an entity solely within the parameters of just one of these endpoints.

In order to have a greater range of flexibility with regards to their placing of the ratings within the economic cycle, agencies have addendums to their ratings. These signals are attached to the ratings in order to signify to the investor the agencies' belief in the current and future creditworthiness of the issuer and/or the issuance. These addendums come in two categories and have different purposes. Firstly there is the *rating outlook*, which represents the agency's opinion on the development of the credit rating over the medium term. Then there is the *rating watchlist*, which is a stronger, more concerning statement for the issuer and

[80] Trueck and Rachev (n 40) 14.
[81] ibid 17.

focuses upon a much shorter time horizon, usually around three months[82]. The watchlist comes into effect when a deviation from an expected trend takes place or is expected to take place, in which case additional information is required based upon the given scenario[83]. Bannier and Hirsch note that while rating downgrades alert the market to issuers' lack of *capability* to maintain their credit quality, 'watchlist-downgrades allow to inform market participants of borrowers' lack of *success* in the attempt to do so'[84].

These market signifiers are of crucial importance in the capital markets as the fluidity of the marketplace requires constant attention. Any delay in action or information could cost vast sums of money for those exposed to certain circumstances; this is clearly evident within the securitisation process[85]. Though this chapter will not go into tremendous detail regarding the securitisation process, it is worth mentioning the role of the industry[86] in the process in light of the analysis above. In doing so we may then be able to better understand the regulatory analysis that follows.

Asset securitisation involves the pooling of a certain category of loans into a pool that is then sold to investors. The interest and principal payments of these loans are paid to investors in a particular order, dependent upon which slice, or 'tranche' (French for slice) of the pool they purchase (this process is known as 'credit enhancement', as it allows the agencies to attach

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[82] Christina E Bannier and Christian W Hirsch 'The Economic Function of Credit Rating Agencies – What Does the Watchlist Tell Us?' [2010] 34 Journal of Banking & Finance 12 3037.
[83] Trueck and Rachev (n 40) 15.
[84] Bannier and Hirsch (n 82) 3048.
[85] For a more extensive assessment of the mechanics of securitisation see John Deacon *Global Securitisation and CDOs* (John Wiley & Sons 2004); Vinod Kothari *Securitisation: The Financial Instrument of the Future* (John Wiley & Sons 2006) 4-5. With regards to the importance of information to the process of securitisation, Queisser notes that 'the absence of price signals will lead to the misallocation of resources and to a bundling of risk. Intermediation through different channels will improve resource allocation since corporate bond and equity markets will give price signals which reflect risk-levels and provide information to market participants', see Monika Queisser 'The Role of Pension Funds in the Stabilisation of the Domestic Financial Sector' in Douglas H Brooks and Monika Queisser *Financial Liberalisation in Asia: Analysis and Prospects* (OECD Publishing 1999). See also Essvale Corporation *Business Knowledge for I.T. in Islamic Finance* (Essvale Corporation Limited 2010) 81 for a similar assessment of the importance of information to the securitisation process.
[86] See Frank J Fabozzi, Anand K Bhattacharya, William S Berliner *Mortgage-Backed Securities: Products, Structuring, and Analytical Techniques* (John Wiley & Sons 2010); Marco Pagano and Paulo Volpin 'Credit Ratings Failures: Causes and Policy Options' [2010] 25 Economic Policy 62.

higher ratings to the product as a whole and thus make it more marketable). Credit rating agencies give the most secure tranches their highest rating, which in turn encourages risk-averse and regulatory constrained investors to partake in the process[87]. The pool is divided into particular categories of tranches, with the senior category being followed by the mezzanine tranches and then finally by the equity tranches, with the investors in the equity tranches the least likely to be paid in the event of a pool-wide default. For the process to work investors must invest into each division of the pool. With regards to Residential Mortgage-Backed Securities that came to define the Financial Crisis, the Banks invested in the senior tranches, the insurance industry invested in the mezzanine tranches (still rated A by the agencies), and the hedgefunds invested in the equity tranches, chasing the huge returns their clients demanded of them[88].

It is worth noting the fee structure that agencies adopted, primarily through this extraordinary and complicated[89] process. In 2007, a representative fee for a long-term corporate bond issue ranged from 2 to 4.5 basis points of the principal for each year the rating was maintained, and 12 basis points for Collateralised Debt Obligations (Structured Finance Instruments used in the securitisation process)[90]. A basis point represents 1/100th of 1 percent, so an issue of $1 billion would cost the issuer $1.2 million at 12 basis points, for example. Though this rate looks inconsequential, the trillions of dollars' worth of securitised products that were rated during such a short period demonstrates the precise reason for the record-breaking revenues

[87] Mark Zandi *Financial Shock: Global Panic and Government Bailouts – How We Got Here and What Must Be Done to Fix It* (FT Press 2009) 117.
[88] ibid.
[89] Richard C Koo *The Escape from Balance Sheet Recession and the QE Trap: A Hazardous Road for the World Economy* (John Wiley & Sons 2015) 124.
[90] Naciri (n 36) 16.

collected by the agencies since the turn of the century. For corporate and sovereign issues the fees are much more modest, though still extremely lucrative[91].

1.3.3 Credit Rating Agencies and Issuers: A Two-Way Street

It is worth considering that although the issuers depend on the agencies to facilitate the distribution of their issuances throughout the capital markets, agencies depend upon the issuers to maintain their position. Whilst it is argued that agencies preserve the value of their ratings by maintaining a good reputation for the accuracy of their service[92], this remains a controversial issue, as we shall see in the following chapters. However, what is true is that despite the criticisms of the agencies, their reputation is dependent upon the truthful disclosure from the issuing party[93]. Though there are regulations to force this from the issuer, the agencies are still at the mercy of the issuing party, a fact proven by the Enron scandal[94].

In addition to this, there are two competing views as to the informational value of the ratings produced by the agencies. One side argues that the agencies are specialists in procuring and processing financial information, ultimately generating previously unknown information for the financial marketplace. The other side however argues that the agencies merely process

[91] Moody's and S&P have listed prices of 3.25 basis points on issues going up to $500 million, with a maximum fee of $125,000 (S&P) and $130,000 (Moody's). Both firms then charge an additional 2 basis points on amounts exceeding $500 million, see Tony Van Gestel and Bart Baesens *Credit Risk Management: Basic Concepts: Financial Risk Components, Rating Analysis, Models, Economic and Regulatory Capital* (OUP 2008) 153. Sovereign fees tend to range from $60,000 to $100,000, see Naciri (n 36) 16.

[92] Howell E Jackson 'The Role of Credit Rating Agencies in the Establishment of Capital Standards for Financial Institutions in a Global Economy' in Eilis Ferran and Charles A E Goodhart *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing 2001) 312.

[93] Orkun Akseli 'Was Securitisation the Culprit? Explanation of Legal Processes Behind Creation of Mortgage-Backed Sub-Prime Securities' in Joanna Gray and Orkun Akseli *Financial Regulation in Crisis?: The Role of Law and the Failure of Northern Rock* (Edward Elgar Publishing 2011) 11.

[94] For analysis of the Rating Agencies' involvement in the collapsing of Energy giant Enron Corporation in 2001 see Macey (n 106); Hill (n 106). For more on the collapse more generally see Denis Collins *Behaving Badly: Ethical Lessons from Enron* (Dog Ear Publishing 2006); Malcolm S Salter *Innovation Corrupted: The Origins and Legacy of Enron's Collapse* (Harvard University Press 2008); Frank Partnoy *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets* (Profile Books 2010).

publicly available information that results in a general lagging in the financial marketplace with respect to information[95]. Whilst these arguments each have merit, the introduction of regulatory reliance fundamentally altered the character and trajectory of the industry. It is at this point that introducing the nature of the regulatory parameters that theoretically constrain the ratings industry will be beneficial to our understanding of the industry as a whole.

1.4 A Snapshot of the Regulatory Framework

Before this section begins it would be perhaps useful to draw a distinction between two different connotations when the word 'regulation' is introduced to the credit rating discussion. On the one hand credit ratings are used by regulators to affect other parts of the economy. For example, banking regulators have, since the 1930s, required that banks only hold assets that are considered 'investment grade' by the leading rating agencies (it is acknowledged that after the Dodd-Frank Act this is technically not the case anymore); this may be known as 'regulatory usage' of credit ratings. On the other hand is the regulation *of* the credit rating agencies, which dictates actions they must take to be considered as a registered and usable rating agency.

Now that this distinction has been made, it must be stated that credit ratings have a variety of uses in terms of regulatory usage, and are utilised by regulatory agencies across a broad spectrum of financial industries. They are used to identify or classify assets, provide a credible evaluation of the credit risk associated with assets purchased as part of a securitisation offering, determine disclosure requirements, and also to determine prospectus

[95] Roman Kräussl 'The Impact of Sovereign Rating Changes During Emerging Market Crises' in Michael Frenkel, Alexander Karmann, Bert Scholtens *Sovereign Risk and Financial Crises* (Springer Science and Business Media 2013) 92.

eligibility, though the most common usage by the authorities is to use them to determine capital requirements[96]. This is in relation to the usage of the ratings to designate the permissible or required investments of certain financial institutions, like banks or institutional investors[97]. The ratings are used to ensure that risks are 'properly managed, disclosed and priced, as well as supported by sufficient capital to protect certain classes of claims holders, including depositors and policy holders'[98]. This concept of protection is also witnessed in the fact that structured securities are rated by 'one or more credit rating agencies, especially when they are sold to retail (non-professional) investors'[99].

With regards to the regulation *of* the credit rating agencies, and in keeping with the characteristic of complexity that seems to be inherently attached to the provision of credit ratings, the regulatory environment is, and perhaps always has been a complicated affair. One of the main reasons for this is that up until 2006 the Ratings Industry was not extensively or directly regulated. Before this the Industry was subject to being used in regulations and legal considerations regarding a number of different areas of the economy, but was never directly regulated whilst being elevated to such an influential position. For example, before the Great Depression it was the Judiciary who were mainly involved with any sort of 'oversight' of the industry, although that mostly took the form of actions against the agencies for defamation arising out of the content of their publications[100]. In the wake of the Great Depression, regulators such as the Comptroller of the Currency began to incorporate the ratings of the

[96] Alcubilla and del Pozo (n 9) 16.
[97] ibid 17; United States Senate, Permanent Subcommittee on Investigations *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (GPO 2011) 27.
[98] Crockett (n 49) 43.
[99] Alcubilla and del Pozo (n 9) 17.
[100] The 'Reports' of the Credit Reporting Agencies, the precursor to the modern day rating agency, and the ratings of the very early rating agencies such as John Moody's Companies, Standard Statistics, and Henry Poor's Company, were regularly the object of the Judiciary's considerations in libel cases. For more on this fascinating era for the Industry see Marc Flandreau and Gabriel G Mesevage 'The Untold History of Transparency: Mercantile Agencies, the Law, and the Lawyers (1851-1916)' [2014] Enterprise and Society 220. The vast majority of the cases held that the products of the agencies did not represent 'privileged communications' owing to the fact that the agencies could not guarantee that the details could be restricted to the purchasing subscriber. The authors detail the methods used by the agencies to circumvent this legal barrier.

agencies into their regulations of certain financial markets[101], embedding them into important financial sectors whilst the industry remained free from direct regulation. This practice continued, with the Industry being directly excluded from the landmark pieces of legislation that defined the post-Depression era[102]. In 1973, the SEC promoted 'Rule 15c3-1' (later promulgated in 1975), which had the effect of attaching the ratings of the agencies to the Net Capital requirements that constrained brokers and dealers by way of 'haircuts'[103].

This Rule however subsequently introduced the first element of regulation concerning the Industry directly, although to call it regulation is slightly misleading. In order to clarify which agencies' ratings were to be used when formulating the 'haircuts', the SEC attributed the term 'Nationally Recognised Statistical Rating Organisation' (NRSRO) to a small number of agencies[104] through a process known as the 'no-action letter', which entailed SEC staff not recommending 'enforcement action against broker-dealers who used the agency's ratings for purposes of complying with the net capital rule'[105]. This attribution in turn conferred the NRSRO status throughout all other US statutes and regulations were it was deemed appropriate.

This was the environment up until 2005. The emphasis began to change for a number of reasons, although two are logically more relevant than any others. Firstly, it has been widely

[101] In 1931 the Comptroller of the Currency John W. Pole began a procedural change in the Office's valuations of bonds in national bank portfolios, namely that bonds held by these banks rated below the BBB threshold could no longer be held and had to be written off, for more see Herwig P Langohr and Patricia T Langohr *The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They are Relevant* (John Wiley & Sons 2010) 429; Marc Flandreau and Joanna K Sławatyniec 'Understanding Rating Addiction: US Courts and the Origins of Rating Agencies' Regulatory Licence (1900-1940)' [2013] 20 Financial History Review 3 238.

[102] The Banking Act of 1933 and the Securities and Exchange Act of 1934 only specified that the regulations of the given regulatory body (the OCC) be confirmed by those laws.

[103] 17 C.F.R. 240.15c3-1; H David Kotz, the Inspector General for the SEC from 2007 to 2012, describes a 'haircut' in relation to Rule 15c3-1 as the 'Rule that requires that a broker-dealer, when computing net capital, deduct from its net worth a certain percentage of the market value of its proprietary securities position, known as a "haircut"', see H David Kotz 'The SEC's Role Regarding and Oversight of Nationally Recognised Statistical Rating Organisations' [2009] 458 Securities and Exchange Commission: Report of the Inspector General.

[104] The term was declared by the SEC in the amendments to Rule 15c3-1, see *Notice of Revision Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934,* Release No. 34-10, 525, 1973 SEC LEXIS 2309 (Nov. 29, 1973).

[105] Alcubilla and del Pozo (n 9) 6.

noted that whilst rating agencies are not technically set up to detect fraudulent activity, their performance in the Enron scandal was far from desirable, particularly as up until four days before declaring bankruptcy Enron's debt was still rated as 'investment grade' by all of the major agencies[106]. When we include the involvement of the ratings industry in the Asian Financial Crisis of the late 1990s[107], together with the fact that The Big Three's revenues and profits were consistently rising since the turn of the century, it is clear to see why legislators felt the need to introduce legislation for this industry for the first time.

The Credit Rating Agency Duopoly Relief Act of 2005[108] was primarily concerned with the resolving of what was recognised as a 'Catch-22' situation whereby new entrants to the industry had to be nationally recognised in order to gain a licence, yet could not be nationally recognised without having been granted a licence. The Duopoly Relief Act's proposed resolution was to remove the SEC's designation system and introduce a system whereby an agency that had been registered and operating for no less than three years could be granted NRSRO status[109]. The Duopoly Relief Act also sought to increase the capability of the SEC to interfere with the processes of the agencies, in spite of the Act's admonition of the SEC for its role in creating an artificial barrier to entry. However, this was vehemently opposed and eventually diluted in the final version of the Act so that the SEC could not interfere with aspects such as rating methodology. The Act was eventually enacted in 2006.

The Credit Rating Agency Reform Act of 2006 was enacted to 'improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency,

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106 Claire A Hill 'Regulating the Rating Agencies' [2004] 82 Washington University Law Review 1 43. See also Jonathan R Macey 'A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficiency of Mandatory Versus Enabling Rules' [2003] 81 Washington University Law Quarterly 329 for further analysis of the failings of the CRI in relation to Enron's collapse.
107 For detailed analysis on the ratings agencies' involvement in the crisis see Giovanni Ferri, Li-Gang Liu, Joseph Stiglitz 'The Procyclical Role of Rating Agencies: Evidence from the East Asian Crisis' [1999] 28 Economic Notes by Banca Monte dei Paschi di Siena SpA 3 335-55.
108 H.R. 2990.
109 Langohr and Langohr (n 101) 452.

and competition in the credit rating agency industry'[110]. The CRA Reform Act recognised the importance of the industry to the health of the economy, in what it termed its importance to 'interstate commerce', and that the SEC required 'statutory authority to oversee the industry' (something which the SEC had been calling for itself)[111]. It granted the SEC this authority by requiring all NRSROs to officially register with the SEC for the first time.

However, with the CRA Reform Act being retroactive, in that it was promoted as a result of findings from the Sarbanes-Oxley Act of 2002[112] (SOX), it did not prepare the regulatory environment for what was to happen just two years later. In fact, the only mention of mortgage-backed securities in the CRA Reform Act was that agencies were prohibited from threatening an issuer with a ratings downgrade or withdrawal in the event that the agency was not to rate the entire pool of assets (a process referred to as 'notching')[113].

The legislative framework surrounding the ratings industry was therefore strengthened by the Dodd-Frank Act, which was a wide ranging piece of legislature enacted in direct response to the systemic crisis experienced in 2007/08. With regards to the Ratings Industry, the Dodd-Frank Act was particularly extensive, amending numerous elements of the Securities and Exchange Act of 1934 that had been the dominant statute up unto that point (taking into consideration numerous amendments throughout the years of course). Just some of the highlights of the Dodd-Frank Act included removing regulatory reliance upon the ratings of the industry by way of striking references to NRSROs within laws and regulations; increasing disclosure to the SEC; increasing internal compliance structures; changes in the rules governing the relationship between agency members and issuer members; and crucially the removal of legislative protection regarding their liability against legal action (in that the

[110] 120 Stat. 1327.
[111] ibid.
[112] 116 Stat. 745.
[113] (n 110).

products of the agencies do not merely represent 'journalistic opinions' unreservedly protected by the First Amendment, as was previously the case), although there are many more. The Dodd-Frank Act also instructed the SEC to introduce the Office of Credit Ratings, to 'monitor the activities' and conduct examinations of registered NRSROs to 'assess and promote compliance with statutory and Commission requirements'[114].

The legislation covering the practices of the rating agencies are therefore administered and monitored by the regulatory body, the Securities and Exchange Commission. Non-compliance with these rules may be subject to fines or a withdrawal of registration. However, the presence of potentially fraudulent activities concerning the rating agencies' role in the securitisation process[115] means that these punishments are simply not appropriate, in theory. When fraudulent activities are suspected, with there being enough evidence to indict, the US Department of Justice is apparently the body that enters the regulatory framework. The issue of fraudulent activity within the financial markets comes under the collaborative mandate of the Financial Fraud Enforcement Task Force[116], with the DOJ taking the lead role in prosecuting those accused[117]. The difference in penalty is no different it appears, given the recent settlement between the DOJ and Standard & Poor's when S&P was fined a record $1.375 billion for its role in the losses of federally insured institutions[118]. During the investigation S&P had accused the U.S. Government of indicting the agency simply because S&P had lowered the United States' sovereign rating, which perhaps indicates the level of effrontery that exists within the Big Three. Unfortunately, as part of the settlement S&P were

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[114] Securities and Exchange Commission *About the Office of Credit Ratings*.
[115] The Senate Committee charged with investigating the causes of the crisis referred to the word 'fraud' 157 times during their investigation across the whole spectrum of the financial arena with respect to the Financial Crisis, leading senior figures to question the lack of prosecutions as a result, see Judge Rakoff's comments in Frank Vogel 'Top Bankers Evaded Financial Crisis Justice – and Will Never Be Prosecuted For Their Crimes' [2014] The Huffington Post (Jan. 14).
[116] The Financial Fraud Enforcement Task Force was created in 2009 by President Barack Obama and consists of 20 US Governmental agencies mandated to combat and prosecute financial fraud, for more information on the task force and its composition see Financial Fraud Enforcement Task Force *About the Task Force* (2015).
[117] Department of Justice *Offices of the United States Attorneys: Securities Fraud* (2015).
[118] See (n 5).

allowed to deny any violations of the law, although it did sign a statement of facts acknowledging that its executives delayed implementing new models that produced more negative ratings in 2005[119]. This was accompanied by an agreed upon apology by S&P for accusing the government of foul play.

Although this thesis is predominantly focusing upon the regulatory framework surrounding the ratings industry in its host jurisdiction, the United States, one international body is seemingly important to the framework in terms of setting standards that national legislators then incorporate. The International Organisation of Securities Commissions (IOSCO) is an international body founded in 1983 and based in Madrid, Spain, that 'brings together the world's securities regulators and is recognised as the global standard setter for the securities sector'[120]. Before the Crisis it laid out its principles regarding the rating industry, firstly in 2003 with its 'Statement of Principles Regarding the Activities of the Credit Rating Agencies', and then in 2004 with its 'Code of Conduct Fundamentals for Credit Rating Agencies'[121]. Led by a Commissioner of the US SEC (Roel C Campos), IOSCO affirmed four key principles: that rating actions should reduce information asymmetry; should be independent; should pursue transparency and disclosure, and should maintain in confidence all non-public reports[122].

While the principals are important, it is the Code of Conduct Fundamentals that is of most interest. Revised in 2008 and again in 2015[123], it originally prescribed that the CRAs should each 'adopt, publish, and adhere to its Code of Conduct'[124]. This is demonstrable of the issues that surrounded the ratings industry prior to 2006. The Code of Conduct Fundamentals, as

[119] Viswanatha and Freifeld (n 5).
[120] IOSCO *About* (2015).
[121] Langohr and Langohr (n 101) 443.
[122] ibid.
[123] IOSCO *Code of Conduct Fundamentals for Credit Rating Agencies* (2015).
[124] Langohr and Langohr (n 101) 443.

well as the Principles, is referred to as 'Soft Law'[125], meaning that they are not legally binding. The organisation allows for a great deal of discretion on behalf of the agencies in light of this fact[126], and operates a 'comply-or-explain' principle with regard to the adherence of their prescribed regulations[127]. While one could be forgiven for thinking that such a permissive framework would lead to noncompliance, the agencies were already in compliance (and even more so) with the proposed regulations before they were enacted by the IOSCO[128], which may hint at the level at which the proposals were pitched.

In the aftermath of the Crisis the organisation revised their regulations with the 2008 version of the Code of Conduct Fundamentals. In that version they sought to strengthen the rules aimed at preventing or limiting conflicts of interest, the separation of analysts from the commercial side of the ratings business, and rating methodology transparency with particular regard to the separate definition of rating symbols for structured products[129]. Whilst their regulations may be non-binding, they did have a tremendous effect upon regulations that were being constructed at the time, particularly in the US and the EU. This multilateral approach is perhaps indicative of the complexity involved in regulating this unique industry.

[125] Chris Brummer and Rachel Loko 'The new politics of transatlantic credit rating agency regulation' in Tony Porter *Transnational Financial Regulation After the Crisis* (Routledge 2014) 161.
[126] Tony Porter 'Introduction: post-crisis transnational financial regulation and complexity in global governance' in Tony Porter *Transnational Financial Regulation After the Crisis* (Routledge 2014) 14.
[127] Lucia Quaglia *The European Union and Global Financial Regulation* (OUP 2014) 88.
[128] Brummer and Loko (n 125) 162.
[129] Quaglia (n 127) 88. Today the agencies attach additional symbols to their structured finance ratings to differentiate it from their corporate bond ratings, see Moody's (n 53) 4 for the addition of 'sf' to structured finance ratings.

1.5 Conclusion

The aim of this chapter was to provide a primer on the credit rating industry. Having established this elementary foundation, the thesis can now embark upon more complex arguments regarding the nature of the industry and the provision of ratings moreover, all for the purposes of introducing a reform proposal that may be able to address deficiencies in the provision of ratings and redress the Industry's role in the economy for the good of the wider public. The chapter was tasked with answering three main questions: Who are the Rating Agencies? What is it that they do (and what is their role)? And finally what is the regulatory framework that governs them?

Firstly we were introduced to the 'Big Three': Moody's; Standard & Poor's; and Fitch Ratings. These three agencies are extraordinarily dominant in the global provision of credit ratings, and have capitalised upon their position to become major factors in the global economy. Furthermore, we saw how these agencies have diversified their business models in response to the securitisation boom in that they now all offer 'Ancillary Services', which include many important *influential* elements rather than just being 'products and services that are not credit ratings' as we heard from Moody's. The divisions actually play a vital role in building the fortunes of the agencies, in that they not only provide additional lucrative services that are essentially addendums to the business of producing credit ratings, but they control and manage the company's sales and marketing elements as well. This is a particularly important consideration for this thesis.

The next challenge for the thesis was to detail and analyse the role of the industry within the economy. This endeavour also included assessing what the agencies actually did, who uses their output, and how they conducted their business; the answers to these questions result in an interesting conclusion. Whilst the many criticisms that will be incorporated into the rest of this thesis regarding the credit rating agencies are for the most part valid, it is extremely important to remember that the ratings industry plays a crucial role in the modern economy. In section *1.2 The Industry: What It Does*, we saw a wide range of elements that attest to this understanding; the agencies are perhaps 'all things to all men'. Investors find them extremely useful and use them strategically to protect and advance their position, whereas issuers *rely* on the agencies to facilitate their existence and provide the mechanism (debt issuance) to support their organisational requirements. The vast capital markets also rely upon the agencies, in that the trust to commit to the exchange, whether by investing or issuing, is fundamentally tied to the trust in the accuracy of the rating agencies' output. We shall also see in the next chapter how the role of the Industry is *ideologically* important to this market-driven modern society[130]. These assertions provide great examples of why the regulation of these entities has to be flawless.

The multilateral regulatory framework that governs the credit rating industry is fascinating. It is fascinating simply because it is tasked with regulating a truly unique industry. We saw in *1.3 A Snapshot of the Regulatory Framework* a system that has a number of competing viewpoints and agendas. The SEC have been tasked with being at the forefront of regulating and monitoring the ratings industry, as prescribed by the Credit Rating Agency Reform Act of 2006, and the Dodd-Frank Act of 2010. Yet, a large number of the prescribed rules that the Commission must ensure compliance with came from the collaborative efforts of the IOSCO. Whilst the internationally collaborative efforts of the IOSCO sound appealing, different jurisdictions are exposed to the positive and negative elements of the ratings industry in differing levels; this inclusion of competing perspectives has the potential to impede effectual

[130] This issue forms a major part of the next chapter. For a basic overview of this importance see Gregory Husisian 'What Standard of Care Should Govern the World's Shortest Editorials? An Analysis of Bond Rating Agency Liability' [1989-90] 75 Cornell Law Review 415-18.

development. Furthermore, when things become sensational, the SEC is removed out of the equation[131], indicating a regulatory framework that is dominated by competing pressures rather than a shared vision.

Perhaps in light of this, there is a continued criticism of the regulatory framework that governs the ratings industry. The response to the era-defining Financial Crisis has had a number of effects. Firstly, it has illustrated the serious flaws that existed before the crisis. The sheer number of aspects included in the Dodd-Frank Act concerning credit rating agencies suggests that the regulatory framework pre-crisis was simply not good enough; the understanding that the industry was not *directly* regulated before 2006 is perhaps shocking in itself. Secondly, it has illustrated the response that is viewed by those who can affect change as being appropriate or achievable. In finding that the leading agencies conducted their business fraudulently, deceiving and failing large and important institutional investors, the fact that the only viable option available to the United States Department of Justice was a $1.375 billion fine is perhaps representative of the state of affairs, particularly when we consider that the DOJ was originally seeking to fine S&P $5 billion[132]. The fact that continued claims of deliberate fraudulent activity have not resulted in any criminal prosecutions is telling. What it may also represent is the parameters within which any reform proposal aimed at correcting imbalances within the Ratings Industry should be placed. This thesis is mindful of this and aims to consider its reform proposal within exactly these parameters.

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[131] Two examples provide evidence of this. Firstly, the establishment of the US Treasury Department (together with the Federal Reserve) as the leading agency in resolving the Financial Crisis was extremely telling, see Lawrence A Cunningham and David Zaring 'The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response' [2009-10] 78 George Washington Law Review 39, for a review of the positioning of the two agencies through the crisis. Secondly, the opportunity to exact some relatively meaningful (and public) punishment was taken by the US Department of Justice in fining S&P $1.375 billion, not the SEC.

[132] David Fickling 'S&P, RBS Lose Appeal of Ruling Australian Towns Misled' [2014] Bloomberg (June. 6).

Now that we have an understanding about who the credit rating agencies are, what it is that they do, their role within the economy, and the regulatory framework that governs them, it is now important to ask more probing questions. If the proposal that rating agencies be forced to choose between producing credit ratings or providing ancillary services, in order to align their output to the public interest more closely, is to be communicated effectively, then understanding the dynamics of their position is clearly important. Now we shall assess not only the role of the agencies, but crucially how that role is *intellectually created* and *perceived*, rather than it being a natural role that they inhabit. In addressing the creation of that role and how it is perceived, patterns emerge that suggest that the escalation of the agencies' position *despite* having their regulatory assistance withdrawn is due to a historical belief in the capability of the ratings industry to serve anything other than itself. Unfortunately, regulators and legislators are badly misguided in this belief.

The next task of the thesis is to address what may be termed the 'normative': to identify what role the credit rating agency *ought* to play, both in terms of what is expected from them from a number of parties *and* what they themselves profess to do. Having achieved that, we can then go on to measure the extent to which, in actual reality, agencies have failed to measure up to this normative expectation; Chapter 2 achieves both of these tasks.

Chapter 2 – The Divergence Between The *Actual* and The *Desired*

2.1 Introduction

As was stated in 0.1 *Research Methodology*, this thesis can be categorised as a normative endeavour. Whilst the approach of establishing what *is* and then advancing a projected version of what *ought* to be is the quintessential normative approach, this thesis, as discussed in 0.1, requires a slightly different approach, simply because of the nature of the ratings industry. In order to advance the sentiment of the thesis, it will be necessary to firstly establish what *ought to be,* then evaluate how and why the agencies do not meet this standard, and then prescribe a measure which may contribute to the agencies actually performing in a manner which resembles what was previously advanced as what they *ought* to be doing. However, this simple endeavour becomes a little convoluted when one understands that the normative vision for the agencies, i.e. what they *ought* to be doing, is precisely what it is the agencies say they do; one does not have to develop a new idea here. So, in essence, the aim is to make the agencies behave how they say they do.

This Chapter will begin by doing two things. Firstly, it will establish what certain parties who are irrevocably tied to the agencies *would be reasonably expected to desire from the agencies*. It is worth pausing for a moment here to make this point as clear as is possible: sections 2.2.1; 2.2.2; and 2.2.3 are describing the desires of issuers, investors, and the state, as if they were purely acting how one may reasonably expect them to, almost in the mode of a survey. For example, when we see the desired situation for the state, it is entirely reasonable that the state would want to advance the fortunes of society and not actively seek to harm it, with the state being the manifestation of society. Whilst these *quintessential* positions are admittedly contentious in certain areas (*how* the state should seek to advance the fortunes of society may be different to different people for example), it is a useful foundation for us to show the *divergence* that exists with regards to the ratings industry. That divergence will be demonstrated when we go through 2.3 *The Actual Situation*, because we shall see that nearly all of the parties act in a very different manner to how one may reasonably believe that they should; this then provides us with the basis to assess whether legislation considers the *actual* performance and character of the parties, or whether it looks to bring about the *desired* situation whilst ignoring the *actual*, which will inevitably result in no development at all.

With what is to be reasonably expected of these parties being established in the first three subsections, the second aim of 2.2 *The Desired Situation* will then be met. The *normative* aspect of this Chapter actually lies in the subsection, 2.2.4 *'Public Interest' or 'Public Protection'?*, because all that went before it, i.e. the desired situation for issuers, investors, and the state, all essentially form a survey of what any rational thinker may expect of each party. In 2.2.4 however, the thesis will raise its metaphorical head above the parapet and declare what it believes should be the way forward for economic reform in general. This takes the form of discussing what is meant by the term 'public interest', because, for the thesis, it is a concept that is easily manipulated to serve certain people to the detriment of the public at large. So, with that in mind, the thesis will call for a change in sentiment with regards to economic reform, so that the notion of 'public protection' is placed at the forefront of legislators' thinking in order to safeguard the most vulnerable in society from the iniquities of the financial sector.

Essentially, the point of this Chapter is not to establish how far the agencies have deviated from what they *ought* to be doing in order to paint a fatalistic picture. The point, which is a key sentiment for the communication of this thesis, is that in order to have any chance of implementing impactful change for the protection of the public we must understand how powerful, entrenched, and callous the agencies are; we must understand our point of departure if we are to arrive at our desired destination.

2.2 The *Desired* Situation

Before we proceed, the point established in the introduction to this Chapter must be repeated. What follows, in terms of the desired situation for issuers, investors, and the state, is purely *what one may reasonably expect these parties to desire*, given the pressures that affect their outlook i.e. investors want returns on their investment, and the state wants to reduce its costs whilst maintaining economic safety. Ultimately, it will help our understanding of what can be done to reform the agencies if we start by understanding the environment within which they operate; as these three parties represent the most important aspects of the environment to the largest rating agencies, understanding what they *ought* to expect will show us how the agencies *ought* to act, which is the foundation required for developing this notion of there being a divergence that needs to be incorporated into rating agency reform.

2.2.1 The *Desired* Situation for Issuers

In the first chapter it was established that credit rating agencies serve a number of important functions with regards to the advancement of an issuer. Initially, we saw how companies would need to engage with credit rating agencies in order to enter the capital markets. Just one reason why a company would want to enter the capital markets in order to raise funds to meet financial requirements is because it represents a viable alternative to issuing stock in the company which, as a system of financing operations, has a number of potentially undesired consequences[1]. Additionally, once the company has decided that it will attempt to raise capital through the issuance of bonds rather than stocks, it requires the rating of a rating agency in order to signal its capacity to repay its obligations and in turn lower its rate of interest upon its payments to the creditor[2].

This issue of reducing the interest payments upon its debt is obviously a crucial aim for any company issuing bonds in the capital market. If we take the quintessential issuer and analyse how it would ideally look at the capital markets, then it is reasonable to come to the conclusion that the aim would be to signal the capacity of the company to repay its debts to the entirety of the marketplace and thus allow for its maximum exposure to the marketplace, which would theoretically have the effect of driving down its interest payments due to the wide variety of potential creditors. Therefore, what is referred to as 'Signalling Theory' is an important aspect for us to consider.

When we analysed the concept of 'information asymmetry' earlier it was done under the guise of the credit rating agencies reducing that asymmetry for investors, in terms of providing a rating that simplified and standardised complex financial information about issuing companies and their bonds[3]. Synergistically, the same role of the ratings industry positively affects the issuer. While reducing informational asymmetry allows investors to theoretically invest with greater confidence in the levels of risk they are undertaking, it also allows issuers access to investors and allows them to drive their interest payments down depending upon the quality of rating they can attract. Rousseau notes that the sheer presence of a high quality credit rating, AAA for example, denotes not only the capacity of the company to repay its debt, but its position within the economy owing to the fact that the high costs of obtaining a rating to low-standard issuers make it highly likely that only a large and

[1] See 1.3. *The Industry: What It Does* (n 45).
[2] ibid (pg 18).
[3] ibid (n 48).

successful entity is able to achieve such a high rating in the first place[4]; there are very few companies in the world that hold such high credit ratings[5].

So, ‘Signalling Theory’ basically details the process whereby issuers who have a good credit quality can communicate this fact to investors to receive a higher market valuation[6]. This is done by issuers divulging sensitive information to the third-party (the rating agency) who can then ‘transform’ this information into a manner that reveals the *implications* of that information without revealing its detailed *content*[7]. This process relies upon both publically-available information and the amount of detail divulged by the issuing company; it is usual practice that the Investment Relations Officer of a given firm will have a very close relationship with the rating agency and will provide information in great detail whilst also communicating why certain decisions have been taken by the management of that organisation[8].

There is however a danger for issuers when issuing new debt instruments, which is why it is extremely important for them that reputable and trusted rating agencies rate their issuances. It is important for a number of reasons. Firstly, the cost of obtaining a rating is particularly high. Secondly, excessive issuance by a company has the potential to demonstrate an air of financial difficulty or the need of the business to avoid traditional financing options i.e. financing from banks that have strict lending practices (theoretically)[9]. So, reducing the cost (by way of reduced interest payments) through obtaining a high rating from a reputable

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[4] Stéphane Rousseau ‘Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-based Approach’ [2005] Capital Markets Institute 8.
[5] At the time of writing only three American-based companies hold AAA ratings: Johnson & Johnson; Microsoft; and ExxonMobile Corp, see Mark Morelli ‘These 3 Companies Have Debt Rated “AAA” But Not All Are Buys’ [2015] Seekingalpha.com
[6] Yair Listokin and Benjamin Taibleson ‘If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation’ [2010] 27 Yale Journal on Regulation 96.
[7] Gianluca Mattarocci *The Independence of Credit Rating Agencies: How Business Models and Regulators Interact* (Academic Press 2014) 1.
[8] Steven M Bragg *Running an Effective Relations Department: A Comprehensive Guide* (John Wiley & Sons 2010) 169.
[9] Mattarocci (n 7) 18.

agency alleviates any concerns regarding the motive for issuing in the first place, thus making their securities more marketable[10].

It is clear to see why rating agencies are considered vital to the health of issuing companies. They stand at the precipice with regards to the navigation of companies through economic cycles. For the issuer, credit rating agencies serve a number of vital functions. Through allowing the company to disclose sensitive information to the marketplace without being at risk of that information being used against them by competitors, the rating agencies allow issuers access to considerable amounts of potential capital with which to fund their operations. They also significantly reduce the level of cost for the issuer by attaching their reputation to the process which reduces their costs by way of monetising the trust that investors have in the agencies. As one can plainly see, the *desired* situation with regards to the issuer is irrevocably dependent upon trust. Issuers rely upon the trust that investors have in the capability of rating agencies to produce impartial financial information, whereas the rating agencies must rely upon the issuers to reveal the correct (and full) information in order for them to formulate accurate ratings, and thus preserve the agencies' reputation. However, this understanding of what is *desired* is just that; in reality the situation is widely different, as we shall see in 2.2 *The Actual Situation*.

2.2.2 The *Desired* Situation for Investors

In the first chapter we saw how credit ratings were seemingly integral to the approach of the investor when deciding where to invest and how to manage that investment. As the majority of investors, of varying levels of capability, have expansive portfolios, the inclusion of highly

[10] Neil D Baron 'The Role of Rating Agencies in the Securitisation Process' in Leon T Kendall and Michael J Fishman *A Primer on Securitisation* (MIT Press 2000) 83.

rated investments allow them to balance their portfolios so that riskier ventures are counterbalanced by the low-yield but highly dependable interest payments accrued from highly rated debt issuances[11]. This concept of providing relative security for an investor was repeated when we assessed the notion of 'agency'. In analysing how dispersed shareholders (and stakeholders) of large institutional investors like pension funds and mutual funds sought to control the actions of their managers, we saw how shareholders utilise credit ratings to impose restrictions on the investment opportunities that managers can engage with[12]. Investors can also use 'rating triggers' to determine a point at which the issuing company must forfeit the original agreement and settle what is owed with the creditor. We learned that the reason for this was to protect the creditor against an issuing company whose ability to repay its debt is tumbling i.e. once the debtor falls below a certain level (rating), repayment (or a restructured agreement) is put into effect[13].

It should be already clear that for the investor credit ratings are an intrinsic part of their operations. Ultimately, investors *desire* a number of things, arguably perfectly reasonable things, from the rating agency. Firstly they require impartiality. They require impartiality in order to be able to trust the ratings of the agencies, and as was asserted above, trust is the underlying principle to the efficient administration of this entire process. They also require transparency[14] in order to be able to check the workings of these third-parties, third-parties who they do not pay for the service, in order to maintain a level of trust to keep the process running. They also require timely information, as the entire system is predicated upon the understanding that 'securities are traded quickly'[15].

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[11] See 1.3. *The Industry: What It Does* (n 46).
[12] ibid (n 63).
[13] ibid (n 70).
[14] Thummuluri Siddaiah *Financial Services* (Pearson Education India 2011) 260.
[15] Baron (n 10).

They require all of these aspects mainly to assist them with their aim of making the *right* investment for their operation. What is right for the investor, and how they will utilise the ratings produced by the agencies is dependent upon their capability; this is often referred to as the difference between a 'sophisticated' and an 'unsophisticated' or 'retail' investor[16]. Retail investors will invariably combine the ratings of the agencies with other statistical features, such as the rate of return, to select the best investment opportunities for their position[17]. Mattarocci notes that 'the user considers the mean default rate related to the rating class and computes the expected return corrected for the default risk for each available instrument'[18]. For sophisticated investors, the analytical role of the ratings is supplementary; it is often the case that these investors have specialised and dedicated offices charged with examining risk within the marketplace (often to a greater extent than the rating agencies themselves)[19]. Perhaps the most obvious reason then for their usage by institutional investors is because they are bound to use them by either their shareholders or regulations, although the regulatory bind has *technically* been eradicated since the enactment of the Dodd-Frank Act in 2010; this will be covered more in Chapter 3 *Why the Agencies Transgress and What Allows Them to Do It* as this simplistic understanding is not quite correct because, as we shall see, the forced usage of ratings as mandated by regulations may have been technically ended with The Dodd-Frank Act by removing all references to the agencies within financial regulations, but their implementation is so embedded after over 80 years that requiring that institutional investors must not *solely* rely on agency ratings was always unlikely to result in the reduction in reliance; the result was that investors no longer had recourse to complain that they had been *forced* to rely on ratings from dishonourable agencies by the state.

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[16] The differentiation between the two categories is far more complex than this simple understanding, and also has a long legal history. For more on the legal history of the differentiation, and the impact of it, see Jennifer G Hill 'Images of the Shareholder – Shareholder Power and Shareholder Powerlessness' in Jennifer G Hill and Randall S Thomas *Research Handbook on Shareholder Power* (Edward Elgar Publishing 2015) 58.
[17] Mattarocci (n 7) 11.
[18] ibid.
[19] ibid.

It is worth pausing here to consider Husisian's exercise, which contemplates what the situation would be if credit rating agencies did not exist. Although, to be sure, there are many factors which make this exercise only theoretical, it is still useful just to imagine this theoretical role of the agencies. Husisian argues that in the event that rating agencies did not exist, then the capital markets would be plagued with high information costs. Such information costs would inhibit action from investors which is, of course, the driving force of the modern economy. He continues by stating that to find profit opportunities within the capital markets 'the investor must spend time and money evaluating the riskiness and potential return of various investment opportunities. The returns from investing in research, however, are likely to be too small to justify much investment. The returns are small because the debenture landscape is so cluttered with differing issues that risk evaluation is very difficult'[20]. This alludes to the fact that the rating agencies, in a perfect scenario, act to facilitate the fluidity of the capital markets, through allowing investors to participate in the process by making it economically viable to do so.

Credit rating agencies are clearly important to the investor. However, when we analyse the perfect model then there are questions raised as to how important rating agencies are for sophisticated investors, although that analysis is not appropriate for this section. Yet, ideally, they are vitally important to facilitating the fluidity of the marketplace. If we then consider that modern society is intrinsically attached to the market and its fortunes, the importance of the rating agencies becomes abundantly clear. It is this notion of structural (and therefore societal) importance that forms the next part of this section.

[20] Gregory Husisian 'What Standard of Care Should Govern the World's Shortest Editorials? An Analysis of Bond Rating Agency Liability' [1989-90] 75 Cornell Law Review.

2.2.3 The *Desired* Situation for the State

These two pillars of modern society - the issuer and the investor - are clearly important for us to examine with regards to the financial system and the conduct of the rating agencies. However, the role of the state in facilitating, and now *unreservedly* protecting the economy makes it perhaps the most important element to consider. We saw in the first chapter how the marketplace requires constant attention, and that how any delays with regards to information or structurally-impactful decisions could cost vast sums of money for interested parties (and sometimes parties that do not have a direct stake in these financial dealings, like the general public for example)[21].

The assumed and attributed position of the state as the lender of last resort (LOLR) makes the state's position the most difficult, the most dynamic and the most important. Langley succinctly suggests that 'it is only because of (state) sovereignty that the endemic crisis tendencies of finance do not realise the ultimate collapse of money, markets, and capitalism'[22]. If were are to accept this understanding, then it is clear that we must acknowledge the potential effect that this dynamic may have upon the likelihood of establishing impactful reforms that may protect the public more, as opposed to facilitating economic movement (many would argue that these are the same thing); this understanding raises the question of where the state's priority lies.

The events of the Financial Crisis made it abundantly clear that the maintenance of the market is the absolute priority. This relates to the widely held notion that a wider social benefit will be the natural result of the maintenance of the market, which is often cited as the rationale for intervening in financial matters, usually at a great cost to society (quantitative

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[21] See 1.3.2 *Signalling to the Market* (n 85).
[22] Paul Langley *Liquidity Lost: The Governance of the Global Financial Crisis* (OUP 2015) 19.

easing leading to austerity measures, for example)[23]. The impact of this dynamic is important for our understanding, but it will be more appropriate to discuss it in 2.3 *The Actual Situation*, mainly because this dynamic has the potential to warp the approach taken by influential market actors, with the obvious example being that excessive risks will be taken by market actors who know that the institutions they represent are simply 'too-big-to-fail'. For now though, it is enough simply to suggest that safeguarding the system is the highest priority for the quintessential 'state'.

When discussing the notion of the 'state' and the 'system', it is very difficult not to move into the direction of theories concerned with capitalism. The intricacies of the social system referred to as capitalism are extraordinarily complex and require much more analysis than this thesis can afford. Yet, one line of reasoning may allow us to move into assessing why the credit rating industry has become so prominent. Tae-Hee Jo suggests, with regards to his systemically centred analysis of business cycles, that business enterprise and the state actively pursue the same goal – 'the stability of the economic system and the existing social order'[24]. As this suggests a common goal, it is interesting that he then notes that 'the state regulates markets primarily in order to protect private enterprises from the macro-uncertainty and –instability'[25]. If this is so, that the state's highest priority is the protection of private enterprises, then the natural question to ask in light of this understanding is how the state would go about performing such a vital task? There are two issues here that will move us towards our analysis of the credit rating industry. Firstly, whilst this society is undoubtedly defined by the market, there are other important elements of society that the state must give its attention to, with societal welfare, threats to its citizens' safety (terrorism for example), or

[23] ibid 16.
[24] Tae-Hee Jo 'A Heterodox Microfoundation of Business Cycles' in Joëlle J Leclaire, Tae-Hee Jo, and Jane Knodell *Heterodox Analysis of Financial Crisis and Reform: History, Politics and Economics* (Edward Elgar Publishing 2011) 114.
[25] ibid 117.

dynamics between sovereign states being good examples. The second issue is that, as we have already seen in 1.3 *The Industry: What It Does*, the onset of the credit rating industry's dramatic rise coincided with the explosion of the capital markets in the 1970s[26]. This explosion had the effect of increasing the macro- and micro-instability within the system due to the rapid increase in participants within the financial system (which increased the systemic exposure to risk), and the amounts being traded (which increased the severity of that risk and the consequences of failure)[27]. These factors contributed to the lessening of the state's capability to fulfil its protectionist obligations.

Therefore, with its capability to protect the system by using its own means declining because of external factors like those mentioned above, the state responded reasonably (in theory) by seeking to outsource these responsibilities to specialist market actors (in the same way investors would constrain mutual fund managers). In continuing our analysis in the section from within the *quintessential* parameters set earlier, there are a number of valid reasons for why the state would want to recruit and incorporate specialist third-parties into the financial stability framework. If we use the example of the credit rating industry, the ability to define the parameters that certain financial sectors can operate within (as we saw earlier with the 'haircut' requirement for broker-dealers[28]) is arguably 'understandable from a public policy standpoint'[29]. It is even more understandable if we were to accept, as the House of Lords suggests[30], that credit ratings are considered to be: easy to use; easily accessible; independent; relatively stable; have a successful track record; and are ultimately non-discriminatory in their publications to the market. This ability to set and maintain prudential standards[31]

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[26] See 1.3 *The Industry: What It Does* (n 47).
[27] Jo (n 24) 117.
[28] See 1.4 *A Snapshot of the Regulatory Framework* (n 103).
[29] House of Lords *Banking Supervision and Regulation: 2nd Report of Session 2008-09, Vol. 2: Evidence* (The Stationery Office 2009) 77.
[30] ibid.
[31] Anjali Kumar, Terry M Chuppe, Paula Perttunen *The Regulation of Non-bank Financial Institutions: The United States, the European Union, and Other Countries, Parts 63-362* (World Bank Publications 1997) 17.

without bearing the entirety of the cost related to that role is obviously an attractive proposition for the state.

The act of outsourcing this responsibility also confers a crucial responsibility upon the market actor. With reference to the credit rating industry (as with the accounting industry, to provide just one other example), this role is commonly referred to as being a ‘gatekeeper’. In outsourcing this responsibility, the states requires, or at least *desires* that the rating industry performs a certain number of tasks. In discussing the gatekeeping function of the credit rating industry, Mohammed Hemraj asserts that essentially the role is that of a decision maker (which would have been the state’s decision to make had it not outsourced the responsibility). He goes on to declare that ‘it is a gatekeeper who decides which information will go forward and which will not. Gatekeeping is therefore a “process of culling and crafting countless bits of information into the limited number of messages that reach people every day”… this process determines not only which information is selected, but also what the content and nature of the message, such as news [or ratings], will be’[32]. Similarly, Coffee defines the gatekeeper as ‘some form of outside or independent watchdog or monitor – someone who screens out flaws or defects or who verifies compliance with standards or procedures’[33].

It is worth noting that the state does not just have one financial gatekeeper in its arsenal; different gatekeepers have different tasks which, theoretically, should all contribute to a tightly-knitted regulatory framework that is much less expensive for the state to coordinate than were it to shoulder the responsibility itself. For example, Credit Rating Agencies are continually at pains to declare that their purpose is not to detect fraud within organisations[34]; that role in the framework has been afforded to the accounting industry. So, whilst rating

[32] Mohammed Hemraj *Credit Rating Agencies: Self-Regulation, Statutory Regulation and Case Law Regulation in the United States and European Union* (Springer 2015) 4.
[33] John C Coffee *Gatekeepers: The Professions and Corporate Governance* (OUP 2006) 2.
[34] See 1.3 *The Industry: What It Does* (n 60).

agencies are not expected to detect fraud, the state does *desire* that they provide market-based verification that will assist investors in making allocation decisions[35], in addition to providing bench-marks for certain market actors. However, with that trusted position comes a certain power, and that power usually stems from the penalties that come with non-compliance with that particular gatekeeper. For example, should an agency withhold its cooperation or consent[36], then not only would an issuer's interest payments rise with a lower rating, but larger investors cannot even attempt to purchase debt that is not of a certain category of rating which means that a large amount of capital is not available to poor-quality issuing companies.

Their position as a gatekeeper is just one element to why rating agencies are considered to be very important by the state. When we consider the state's mandate as discussed earlier, namely that they must seek to protect and advance the system, then the reasons for *desiring* that the agencies perform their tasks to the best of their ability are clear and reasonable. Their verifying role, when combined with the availability of their products, mean that they are vitally important to allowing access to the capital markets (this is where the term 'gatekeeper' is directly appropriate), allowing a wide range of entities access to the markets which is touted as increasing the fluidity, and therefore the health of the economy[37]. The tendency to promote the perceived relationship between economic health and societal health makes this aspect of the rating agencies' role very important indeed.

This aspect of increasing (or at least maintaining) the fluidity within the economy is potentially the most important factor of the rating industry's role from the viewpoint of the state. Mattarocci notes that perhaps the key role within the economy for the credit rating agencies is that the information they produce has the theoretical effect of increasing the

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[35] Mads Andenas and Iris H Y Chiu *The Foundations and Future of Financial Regulation: Governance for Responsibility* (Routledge 2013) 193.
[36] Coffee (n 33).
[37] James Ciment 'Credit Rating Agencies' in James Ciment *Booms and Busts: An Encyclopedia of Economic History from Tulipmania of the 1630s to the Global Financial Crisis of the 21st Century* (Routledge 2015) 192.

overall amount of information within the marketplace more generally, whilst also making the prices of financial instruments more consistent with the real risk-return profile of the issuer and issue[38], thus reducing the potential for any price imbalances within the marketplace. This notion of balance is something that one may rationally expect the state to pursue in its management of the economy.

These issues discussed in this subsection demonstrate a version of what the *desired* situation is for the state. In essence, the aim is to reduce the costs for the state without reducing the influence or capability to affect the direction of the economy. However, this desired situation is predicated upon certain elements existing and being prevalent within the operation of a given entity. For example, rating agencies must be independent to be justifiably considered as an acceptable form of what has come to be termed 'quasi-governance'[39]. This then raises the questions 'if they are not (at least perceived to be) independent, then does that affect the authority of the state?' and 'if the state's authority is reduced by outsourcing, who is then influencing the direction of the market?'

The state therefore has a number of factors that it should be considering, all of which *should* translate to the protection *and* advancement of society. However, the protection of society and the advancement of society are not the same thing. For far too long it has been the prevailing theory that if the market is prepared favourably for advancement, then society will analogously advance also. Now, before we discuss the *actual* situation with regards to investors and the state in relation the rating industry, it will be important to address this notion of 'public interest', because coming to a clear understanding as to what one means by this, in terms of society overall, allows for the reasons for one's actions to become clear.

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[38] Mattarocci (n 7) 18.
[39] Andenas and Chiu (n 35).

2.2.4 'Public Interest' or 'Public Protection'?

The normative discussion regarding the credit rating agencies is potentially very straightforward. Whilst others may seek to fundamentally change the industry, or remove it altogether, it is arguable that if they just performed how they say they perform then there would be very little criticism. So, if that (potentially) covers the issues of how the agencies *ought* to behave, and how the industry *ought* to be, then is there anything more to be said in this regard? In making the jump from discussing a normative vision for the agencies in particular, to discussing the issue of regulating the agencies more broadly, so that the *desired* performance stands a better chance of being realised, this section will now conclude with its normative vision for the regulation of the credit rating agencies. However, whilst the final chapter of the thesis details a precise proposal for regulating a particular component of the industry, this section will look at the broader issues with regard to *sentiment*.

It is widely held that the agencies' output, and the regulation of them, is in the 'public interest'[40]. Yet, if we apply a critical lens to this understanding, then the question must be what connotations does the attachment of that term have upon the effectiveness of regulating such an important part of the financial system? When legislators consider what may be in the public interest, within what framework are they operating? It is argued here that any decision that is taken by legislators, or any of the powerful for that matter, are done so within the parameters of the marketplace, rather than society moreover. The effect of this is that we are left exclusively valuing the *measurable*, rather than regulating for the *valuable*[41].

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[40] Herwig P Langohr and Patricia T Langohr *The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They are Relevant* (John Wiley & Sons 2010) 429.
[41] Mike Feintuck 'Regulatory Rationales Beyond the Economic: In Search of the Public Interest' in Robert Baldwin, Martin Cave, and Martin Lodge *The Oxford Handbook of Regulation* (OUP 2012) 45.

Whilst this view may be contentious, given the dominance of the market upon everyday life, it is certainly not original. In describing the reasons why this market-centric view is problematic, Feintuck states that ‘the frame of reference of the market is too narrow to encompass properly a range of social and political values which are established in liberal democracies and can be seen as constitutional in nature’[42]. To pre-empt the discussion at the end of this subsection for one moment, for this thesis there needs to be scaling-back of the values that Feintuck alludes to here, so that for decision-makers only purely humanistic ills are considered first and foremost, like the marked reduction in ills related to financial crashes i.e. homelessness, suicides, diseases, and increased poverty. To continue, it is absolutely essential that we all remember that the economy is not a natural phenomenon, to which we are all indebted, as Sunstein correctly declares: ‘markets should be understood as a legal construct, to be evaluated on the basis of whether they promote human interests, rather than as part of nature and the natural order…’[43].

This dominance of the market ideal on everyday consciousness has been attributed to a clear alteration in thought that blossomed in the 1980s, shared between the British Government headed by Margaret Thatcher, and the U.S. Administration led by Ronald Reagan. This ideal of economic efficiency driving regulatory policy[44] is the foundation to what Feintuck views as the purposefully-created divergence between the interests of the citizen as a consumer, and the interests of the citizen as a citizen[45]; this helps us to understand the point made earlier regarding what one may mean when they say they are making decisions with the ‘public interest’ in mind – is it in their interests as a consumer, or a citizen? The market-centred

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[42] Feintuck (n 41) 39.
[43] Cass Sunstein *Free Markets and Social Justice* (OUP 1999) 5. Linarelli concurs, noting that ‘Financial markets are, however, totally of our doing. We create them. Our social practices and our actions determine who gets what, who loses, and who gains’, see John Linarelli ‘Luck, Justice and Systemic Financial Risk’ [2015] Journal of Applied Philosophy.
[44] Cento Veljanovski ‘Economic Approaches to Regulation’ in Robert Baldwin, Martin Cave, and Martin Lodge *The Oxford Handbook of Regulation* (OUP 2012) 25.
[45] Feintuck (n 41) 59.

theories that underpin this movement are many, as we shall see later in the thesis[46], and they are dominant, but they are not absolute[47]. What appears to be the case is a clear theoretical and philosophical divide between those who seek to incorporate fundamental human values into society, and those who perceive there to be little need to focus on such large-scale endeavours, following the sentiment declared by Margaret Thatcher that there is 'no such thing as society'[48].

For the viewpoints that *are* concerned with the notion of society, there are two interesting concepts for our discussion. The first is the notion of 'stewardship', which admittedly is usually attributed to environmental concerns. As Lucy and Mitchell tell us, the concept is derived from religion, with Lucy and Mitchell focusing on the Bible, with the concept stemming from the relationship between man and God in relation to the Earth. The notion of 'stewardship' has been enlarged from this initial understanding of man having absolute domain over the resources of the planet (i.e. '…have dominion over the fish in the sea, and over the fowl in the air, and over every living thing that moveth upon the earth'), to one where man is not despotic but rather seeks to act responsibly, and rather than do it for God do it for the wider human community[49]. Feintuck correctly attaches the notion of 'future generations' to this concept of stewardship[50], which is particularly relevant to the discussion here; the sentiment of this thesis is that we must consider more than just what we can see, and that includes future generations as well as those who are cast adrift by society because of destructive finance.

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[46] 2.3.2.2 *Deregulation – A False Diagnosis*
[47] For just some scholars who oppose the market-based view see Feintuck (n 41); Mark Sagoff *Price, Principle, and the Environment* (CUP 2004); Sunstein (n 43).
[48] Feintuck (n 41) 60.
[49] William N R Lucy and Catherine Mitchell 'Replacing Private Property: The Case for Stewardship' [1996] 55 The Cambridge Law Journal 3 583.
[50] Feintuck (n 41) 58.

This cross-generational sentiment is both the greatest strength of the ideal of stewardship, yet it is its greatest weakness[51]. It is a weakness for the advancement of the ideal because it is arguably impossible to come to a consensus regarding what future generations may require, or even what they may want. It is for this reason that the calls of this thesis to eradicate fundamental social ills that are the result of destructive finance are so basic; it was noted earlier in the introduction to the thesis that one cannot have absolute knowledge regarding what is best for everyone, but, problems such as homelessness or poverty in the western world (at first instance) are so basically inexcusable that any calls for them to remain would make for fascinating reading.

The second viewpoint that *is* concerned with society is one aspect of 'public interest' which is usually classified in a trio of accounts. The three accounts of the public interest – the preponderance, the common interest, and the unitary account – are all understandings developed by Virginia Held in 1970[52], and all address the notion of public interest and how to satisfy it. However, for this discussion we will focus mainly on the *Unitary Account*; the preponderance account describes that the public interest is 'equivalent to the greatest sum of individual interests'[53], whilst the common interest account is defined by the understanding that 'what is in the public interest is *always* in one's individual interests (although the reverse is not necessarily true)[54].

The unitary account, however, holds that the public interest 'can be formulated without recourse to individual interests at all and, second, that the assertion that something is in the public interest is an assertion that it is universally morally right or good'[55]. Also, the unitary account differs to that of the others because it recognises that determining what is in the

[51] Lucy and Mitchell (n 49) 590.
[52] Virginia Held *The Public Interest and Individual Interests* (Basic Books 1970) 42.
[53] Lucy and Mitchell (n 49) 588.
[54] ibid 591.
[55] ibid 594.

‘public interest’ is a purely normative endeavour. Lucy and Mitchell continue by stating that the account holds that there can be no conflict between individual interest and the public interest; in the case of conflict one must be mistaken[56]. It is here, though, that the potential problems with this mode of thought begin to appear, because as Held identifies: ‘to assert that someone involved in such conflicts is always misguided, or that one of any two conflicting positions must be evil, is to close one’s sensitivities to the actualities of human affairs’[57]. This idea of an ideal being in the interests of the public, based on a moral footing, and that conflicting ideas must be ‘wrong’, has a long history and has been associated with some of the most revered philosphers like Plato, Aristotle, and Hegel. However, it has also been (rightly) associated with the Soviet Union and Nazi Germany as the basis for their persecutions of non-conformists or those classified as ‘different’, and to the Church with its persecution of female healers (witches), to provide just three examples[58].

The call that this thesis makes, that we should consider eradicating a number of social ills when deliberating on economic reform, is most likely classified as falling within the unitary account. The examples given above of Nazi Germany, the Soviet Union, and the Church, are excellent examples of the power of man to warp the notion of the public interest, which is why the notion of this thesis is so basic, perhaps even rudimentary. The notion that we must strive to eliminate the connection between financial crises and social ills like homelessness,

[56] ibid.
[57] Held (n 52) 156.
[58] Mike Saks *Professions and the Public Interest: Medical Power, Altruism and Alternative Medicine* (Routledge 2005) 37-9.

suicides, mass unemployment, family breakdown, and even cancer-related deaths[59], is *almost* impenetrable to the iniquities of man. Therefore, this thesis operates on the basis of reducing the social damage that destructive finance causes, and develops a reform proposal to assist in that aim - it is perhaps better to think of this ideal as 'public protectionism', rather than striving for what is in the 'public interest'. The *normative* vision for this thesis is that the rating agencies are to be *constrained* so that they have no option but to operate how they say they do. Then, and only then, can the goal of reducing the impact of fraudulent, dishonourable, illegal, and ultimately immoral finance upon society as a whole, and in particular the vulnerable, be realised.

2.3 The *Actual* Situation

In the previous section the emphasis was placed upon understanding what certain parties required of the credit rating industry within a perfect environment. We saw how issuers need rating agencies in order to signal their health to the marketplace, which subsequently allows them access to a wide range of investors whilst also reducing the amount of interest they will have to pay in servicing that debt. We saw how investors require an independent rating agency to compile and classify information so that they can incorporate that synthesised analysis into their own investing approach. Finally we looked at the requirements of the state,

[59] For details on the links between the Financial Crisis and these social ills see: (Homelessness) Aoife Nolan *Economic and Social Rights after the Global Financial Crisis* (CUP 2014); (Suicides) Aaron Reeves, Martin McKee, and David Stuckler 'Economic Suicides in the Great Recession in Europe and North America' [2014] The British Journal of Psychiatry; (Mass Unemployment) United Nations *The Global Economic and Financial Crisis: Regional Impacts, Responses and Solutions* (United Nations Publications 2009) 7; OECD *OECD Employment Outlook 2015* (OECD 2015); (Family Breakdown) Brian Nolan, Wiemer Salverda, Daniele Checchi, Ive Marx, Abigail McKnight, István G Tóth, Herman Van de Werfhorst *Changing Inequalities and Social Impacts in Rich Countries: Thirty Countries' Experiences* (OUP 2014) 722; (Cancer Mortality) Mahiben Maruthappu, Johnathan Watkins, Aisyah M Noor, Callum Williams, Raghib Ali, Richard Sullivan, Thomas Zeltner, Rifat Atun 'Economic downturns, universal health coverage, and cancer mortality in high-income and middle-income countries, 1990-2010: a longitudinal analysis' [2016] The Lancet (Online, May 25).

which requires that the rating industry performs its tasks in a genuine and precise manner, which then allows the state to effectively delegate the *authority* to verify confidential and complex data to the marketplace. In the perfect environment, the state utilises these market actors to coordinate a framework of checks and balances that it can then incorporate into a wider systemically-concerned policy.

As was stated in the concluding remarks of the last section, the issue here is that this ‘perfect’ situation is idealistic. What is *desired* by these parties is proving to be unachievable in the real world. Nevertheless, this understanding has not stopped the incessant quest for attaining it, which is the reason why this chapter plays an important role in communicating the ideas of this thesis. In this section we will see that the *actual* version of events is plagued with imbalances that warp the resulting outputs. Even a cursory analysis of the *actual* will reveal that the divergence between the *actual* and *desired* is so far apart that it makes the concept of attempting to achieve the *desired* without addressing the *actual* a clearly fruitless endeavour. The reasons for this wide divergence will be covered in the next chapter; for now though there are some important aspects to the *actual* that need to be clarified before we progress any further.

This section will not follow the same path as the last section. The last section differentiated systematically between the requirements of the quintessential investor, issuer and the quintessential state. Whilst that was helpful then, what is required now is defined by the actualities of the financial crisis. Talking broadly about the position of the investor and the issuer may be beneficial in certain circumstances, but the aim here is to assess the conduct of the culpable components in the once-in-a-generation event that was the financial crisis. The reason why assessing the financial crisis is so important is because it allows for an extraordinary and perhaps unique insight into the *true* nature of the respective parties. The actions taken in creating and participating in the financial crisis, together with the way in which these parties evaded punishment, represents an opportunity to analyse the true nature of events that is rarely witnessed to such an extent and therefore cannot be overlooked.

So, certain elements need to be clarified in light of this analytical framework that will constrain the following section. Firstly, not all investors partook in the pre-crisis securitisation system that was at fault, so in that sense the issues raised within this section are not completely representative of the relationship between 'the investor' and 'the agency'. Similarly, the Residential Mortgage-Backed Securities (RMBS) market was dominated by only a few issuers, which had the effect of changing the dynamic between 'the issuer' and 'the agency'[60]. In this sense more specifically, the relationship between the issuers of Asset-backed securities and the agency during the build-up to the financial crisis is not precisely representative of the usual relationship between the issuer and the agency. What makes the assessment in this section relevant, in spite of these issues regarding representativeness, is that the financial crisis is in itself representative of a situation that can cause systemic damage, which has obvious benefits for normative analyses. It also serves to highlight, in an extreme fashion, the disposition of the rating agencies (the term 'Big Three' has been purposefully omitted here as other rating agencies have also partook in this systemic abuse of their position[61], allegedly).

Therefore, even though there have been claims that the rating agencies can on occasion even act against the issuer, by way of not factoring into their analysis the constitution of the

[60] Lawrence J White 'The Credit-Rating Agencies and the Subprime Debacle' in Jeffrey Friedman *What Caused the Financial Crisis* (University of Pennsylvania Press 2011) 233.
[61] Egan-Jones Ratings Co. was barred by the SEC in 2012 from rating asset-backed and government securities for 18 months, for the reason that one of their founders, Sean Egan, consciously made misrepresentations to the SEC when the company was applying to gain NRSRO status in 2008 (thus apparently demonstrating their determination to receive some of the residual money that was available before the system completely ground to a halt). See Securities and Exchange Commission 'Egan-Jones Rating Co. and Sean Egan Charged with Making Material Misrepresentations to SEC' [2012] Press Release (2012-75). There is however some doubt as to the legitimacy of this action by the SEC; for more see 4.3 *A Reality Check.*

creditor in the arrangement[62], it will be more appropriate to focus on the effects of the rating agencies upon two parties: the investor and the state. Whilst the majority of investors can quite rightly claim to be victims of the agencies' conduct, there is a line of reasoning that suggests that investors, particularly the sophisticated investors, have no real claim to being an innocent victim in the process, given their expertise. Also, whilst the state is presumed to be solely interested in systemic balance and safety, there is a staggering amount of evidence to suggest that behind almost every crisis lays the state, which creates the fertile ground for such devastating damage (whether they do this knowingly or unknowingly is inconclusive). This research, particularly with regard to the state, has important connotations for what may be possible in terms of reform, so investigating further will be particularly important.

2.3.1 Where Loyalties Lie – The Relationship between the Investor and the Agency

In the previous section we learned that investors, irrespective of their capability, require a rating agency to be independent. They require the agency to be independent so that they can trust the information that they are incorporating into their investment decisions. However, this perfectly rational requirement has not been met by the credit rating agencies, particularly in the build-up to the crisis within the RMBS market. The main reason for this divergence between expectation and reality is the fact that rating agencies are predominantly paid by

[62] Elmar Altvater and Margot Geiger 'Exiting the multiple crises through 'green' growth?' in Andreas Exner, Peter Fleissner, and Lukas Kranzl *Land and Resource Scarcity: Capitalism, Struggle and Well-being in a World Without Fossil Fuels* (Routledge 2013) 19.

issuers under the issuer-pays model, and therefore have a 'vested interest'[63]. Whilst agencies will contest that under normal conditions the conflict of interest inherent in this model is relatively small and also manageable[64], the dynamics of the RMBS market that dominated the financial landscape for over a decade prior to the financial crisis alters that perception immeasurably.

Within the securitisation process, the RMBS products needed to be endorsed by financial entities, predominantly investment banks, through a process known as 'underwriting'[65]. However, the size and scale of these products meant that only a handful of companies had the capability to perform such a vital function, which leads to perhaps the underlying issue with regards to the distasteful conduct of the rating agencies. The SEC noted that whilst 22 different 'arrangers' (issuers of asset-backed securities) underwrote subprime RMBS deals (based on a sample of 642 deals), 12 arrangers accounted for 80% of the total number of that sample, in both number and dollar volume. Furthermore, for 368 Collateralised Debt Obligation (CDO) products accounted for by the sample taken from the Big Three, of the 26 different arrangers who underwrote these products only 11 accounted for a total of 92% of these deals at 80% of the dollar value (12 of the 13 largest RMBS underwriters were also the 12 largest CDO underwriters which served to further concentrate the underwriting

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[63] Faruk Ülgen 'Financial liberalism and new institutional environment: the 2007-08 financial crisis as a (de)regulatory deadlock' in Patrick O'Sullivan, Nigel F B Allington, and Mark Esposito *The Philosophy, Politics and Economics of Finance in the 21st Century: From Hubris to Disgrace* (Routledge 2015) 381. Also, de Lange argues that there are many social and financial ties that lead agencies to favour issuers over shareholders (and investors); chief among which is the fact that 90% of their revenue comes from issuers, see Deborah E de Lange *Cliques and Capitalism: A Modern Networked Theory of the Firm* (Palgrave Macmillan 2011) 124.

[64] Neuman discusses in further detail some evidence that suggests that the sheer amount of business courted by the agencies reduces the likelihood that one issuer may provide enough business to influence the direction or policies of the rating agency, see Nicole B Neuman 'A "Sarbanes-Oxley" for Credit Rating Agencies? A Comparison of the Roles Auditors' and Credit Rating Agencies' Conflicts of Interests Played in Recent Financial Crises' [2010] 12 University of Pennsylvania Journal of Business Law 921.

[65] For a comprehensive guide to 'underwriting' and the importance of investment banks to the modern incarnation of this process see Giuliano Iannotta *Investment Banking: A Guide to Underwriting and Advisory Services* (Springer Science & Business Media 2010).

function)[66]. The SEC went on to make the obvious deduction that 'the combination of the arrangers' influence in determining the choice of rating agencies and the high concentration of arrangers with this influence appear to have heightened the inherent conflicts of interests that exist in the "issuer pays" compensation model'[67].

This dynamic-altering detail is where our analysis of how the agencies differed so much from what was expected of them can begin. We have already seen how the dynamic changed for the credit rating industry in the early- to mid-1970s when the SEC inducted them formally into the regulatory framework[68]. Having grown at an unprecedented rate as a result of this induction, the agencies were in a prime position to take advantage of the next external factor which was the explosion of the asset-backed securities (ABS) market. Partnoy noted that having been invented in the mid-1970s, the total issuance of ABSs in 1987 stood at just $9 billion. Yet, just ten years later the total issuance would be between $100 and $150 billion. In 1995 alone the total issuance was just over $109 billion[69]. This extraordinary rate of increase would be the signal for all the concerned parties within the securitisation chain to begin positioning themselves to take maximum advantage of their respective positions.

Writing in 1999, Partnoy describes a process that demonstrates the issuers' preparedness to manipulate the rating agencies into giving favourable ratings for the structured products being sold, even to the extent that the largest issuers had a 'side-business' that advised clients on how to prepare and 'window dress' their products before courting the agencies for the required ratings[70]. Partnoy suggests that this highlights the fact that the issuers considered the agencies to be easily manipulated. However, whilst this notion is indeed revealing,

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[66] Barry Leonard *Summary Report of Issues Identified in the Security and Exchange Commission Staff's Examinations of Select Credit Rating Agencies* (DIANE Publishing 2009) 32.
[67] ibid.
[68] 1.4 *A Snapshot of the Regulatory Framework* (n 103).
[69] Frank Partnoy 'The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies' [1999] 77 Washington University Law Quarterly 3 664.
[70] ibid 675.

particularly given how long this process must have been occurring, hindsight suggests that rather than being manipulated by devious issuers, the rating agencies were completely willing participants in the larger scheme.

Tymoigne and Wray suggest that the Basel I regulations[71], that were put forward in 1988 and were to be fully enacted by 1992, were the main motive for the innovations in the field of security underwriting[72]. What was quickly realised by the major players within the securitisation process was that the credit rating agencies would take centre stage in the process as a result of the regulations. As a result, 'major innovations had to occur in the credit rating methods because asset-backed bonds cannot be issued without ratings'[73]. Unfortunately, rather than being prudent and accepting the great responsibility that came with this pivotal role, the agencies actively went out of their way to incorporate models that were suspect in order to garner the business of the concentrated issuers. Initially they simply set arbitrary default correlations and default rates based on data available for proxy securities[74]. However, the sheer number of individual assets (mortgages within the RMBS products) that were being packaged together meant that agencies required a method that would both reduce the time it took to come to a decision about the underlying risk, and also give the desired rating that their clients demanded. That method was to be the 'Gaussian Copula Formula'[75].

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[71] Bank for International Settlements *International Convergence of Capital Measurement and Capital Standards* (BIS 1988).
[72] Eric Tymoigne and Larry Wray *The Rise and Fall of Money Manager Capitalism: Minsky's Half Century from World War Two to the Great Recession* (Routledge 2013) 141.
[73] ibid.
[74] ibid.
[75] The full title of the formula is the Gaussian Copula Formula, developed by Dr David X Li. Farrell explains that the equation is used to predict and quantify, for the goal of setting a price, the effects of individual elements so that correlations can be determined (thus providing the opportunity for rating agencies to suggest the risk exposure on thousands of claims with just one symbol), see Joseph P Farrell *Babylon's Banksters: The Alchemy of Deep Physics, High Finance and Ancient Religion* (Feral House 2010) 21-7. For other resources explaining and relating the Gaussian Copula Formula see Dana Mackenzie *What's Happening in the Mathematical Sciences, Vol. 8* (American Mathematical Society 2010) 40; Matthew Watson *Uneconomic Economics and the Crisis of the Model World* (Palgrave Macmillan 2014) 35.

This formula, which under specific conditions was able to produce a single number that was apparently representative of the underlying risk of all the collected claims within the product[76], was perfect for the rating agencies in meeting their clients' demands. However, even though the formula was fully incorporated into the rating system of the major agencies in August 2004, the formula had crucial limits and the agencies knew it. The issue was that whilst the formula allowed them to rate these exotic financial products, they were doing so with little to no underlying data. In order to rectify this potentially fraudulent behaviour the agencies turned to the financial markets for assistance, taking the signals from Credit Default Swaps (CDS) and Equity Default Swaps (EDS) premia, meaning that the amount of protection buyers in securities were paying in premiums was now being factored into the rating process on large pools of individual claims[77]. The issue with this approach however was that the premia of the CDSs and the EDSs were themselves dependent upon the underlying credit ratings. The result of this was a highly procyclical, unreliable and completely inappropriate system of finance that was inherently destined to collapse, leading Tymoigne and Wray to liken the system to a Ponzi scheme[78].

Clearly then the protection of investors (or the taxpaying public) was the last thing on the minds of the agencies. Put simply, the agencies were determined to meet the requirements of only one party; the one that pays the most. There is a technical argument that these agencies should not act in such a mercenary-like manner because their reputation could suffer[79], although there are a number of factors that have contributed to the decreasing effect of this 'reputational capital' deterrent, as we will see throughout this chapter. Furthermore,

[76] Tymoigne and Wray (n 72) 142.
[77] ibid.
[78] ibid.
[79] Howell E Jackson 'The Role of Credit Rating Agencies in the Establishment of Capital Standards for Financial Institutions in a Global Economy' in Eilis Ferran and Charles A E Goodhart *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing 2001) 312. For more on what is referred to as the 'reputational capital' view see Hemraj (n 32) 16; Aline Darbellay *Regulating Credit Rating Agencies* (Edward Elgar 2013) 126.

Tymoigne and Wray cite a former employee of Moody's who suggests that a cultural change took place that completely altered the mind-set of Moody's (and we can safely infer that the other members of the Big Three would follow suit with it being an oligopoly/duopoly)[80].

In what is arguably the most important study conducted on the rating industry, purely for the fact that as an entity the United States Senate can acquire information that no one else can, the United States Senate's Permanent Subcommittee on Investigations' report on the causes of the financial crisis makes for compelling reading. Within this report the notion of cultural change around the turn of the millennium is repeated. The report states that a number of analysts who worked for Moody's during the 1990s and into the 2000s informed the Subcommittee that a 'major cultural shift took place at the company around 2000', from being academically oriented and conservative in its ratings to anything but[81]. Rather unfortunately the Subcommittee, acting on reference from the members of Moody's, attribute this cultural shift to the rise of Brian Clarkson, who would go on to become the Chief Operating Officer of Moody's. However, this timeline coincides with the arrival of a much more influential figure, and arguably one whose arrival is the clearest signal of all that it was understood in the corridors of power that there was serious money to be made in this era.

One of the world's richest people, and widely regarded as one of, if not the greatest investor of modern times is Warren Buffett[82]. In 1999, Warren Buffett's Berkshire Hathaway purchased Dun & Bradstreet. The interesting aspect was that Dun & Bradstreet was not considered to be a great investment at the time because its business of credit reporting was not particularly profitable, even though it was credit reporting that was the ancestor to the modern day ratings industry. But Buffett rarely invests in a speculative manner, and it was

80 Tymoigne and Wray (n 72) 142.
81 United States Senate, Permanent Subcommittee on Investigations *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (GPO 2011) 273.
82 Richard Phalon *Forbes Greatest Investing Stories* (John Wiley & Sons 2004).

not Dun & Bradstreet that was his primary target. Dun & Bradstreet had purchased Moody's in 1962 after John Moody's death[83] and in 1999 was the parent company of an entity that was the key to unlocking the extraordinary profits that were available in the markets, as we have already seen. In an incredible demonstration of stock arbitrage, something Buffett is famous for, he increased his stake in Dun & Bradstreet to 24 million shares for a price of $499 million (at $21 a share), which gave him the power to spin-off the company; the spin-off subsequently took place in September 2000. Under the conditions of the spin-off, Buffett's shares in Dun & Bradstreet were converted into 24 million shares of the standalone Moody's Corporation, which also left him with 12 million shares of Dun & Bradstreet. In the following three years Buffett sold his 12 million shares in Dun & Bradstreet for an average price of $30 a share, resulting in a total of $360 million. This incredible move reduced his overall cost in the stock of Moody's to $139 million, or just *$5.56 a share*[84].

The reason why this information has been included is because it is vital for our understanding of the aims of the credit rating agencies in the pre-crisis era. Rather than attributing the cultural change to internal managers, this is clear evidence that shows the world's most influential people were scrambling to be a part of what was about to happen. What it also does is identify for us that the only consideration for the agencies was profit; Buffett does not invest to contribute to societal balance. This incessant quest for profit is at odds with everything that was required of the agencies as we saw in the last section. There are many examples of the agencies actively operating *against* the interests of the investor and systemic stability; although at this stage it would be helpful to continue to focus on this incredible collusion between the agencies and the small amount of issuers that brought the world to its knees.

[83] Charles R Geisst *Encyclopaedia of American Business History* (Facts on File 2006) 111.
[84] Mary Buffett and David Clark *Warren Buffett and the Art of Stock Arbitrage: Proven Strategies for Arbitrage and Other Special Investment Situations* (Scribner 2010).

2.3.1.1 Collusion

Prior to the Dodd-Frank Act of 2010 the largest of investors were legally bound to invest only in products that were rated at least investment-grade, if not simply AAA. Also, many money managers were bound by the investors they represented to invest only in highly rated products, which relates to the agency-related benefits of credit ratings as we discussed earlier[85]. The clear issue here is that in order to tap into this lucrative market, issuers needed the very highest of ratings for their 'exotic' products. It is worth noting that the majority of investors at this level are 'institutional investors', which means that they are usually representing a large number of policy holders or individual investors (i.e. pension funds or mutual funds for example). That these entities were bound to *only* invest in securities deemed worthy by rating agencies is indicative of the responsibility placed upon the agencies. If we operate for a moment on the hypothesis that rating agencies are *only* concerned with profit and their own advancement, then these factors of issuers willing to pay extraordinary amounts, investors being forced to go through the agencies to invest in securities, and a system that meant even if the agencies' reputational capital was reduced they would still survive all contribute to a seemingly inevitable result. As Senator Richard Shelby declared in the aftermath of the crisis: '…it seems to me that money is trumping ethics…'[86].

Yet, it is arguably the brazenness of the agencies in colluding with the issuers against the investors which is the most relevant aspect. This approach is a telling sign, and one that this thesis argues has to be remembered every time a policy decision regarding the regulation of

[85] 1.4 *The Industry: What It Does* (n 63).
[86] United States Senate, Committee on Banking, Housing, and Urban Affairs *The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets* (GPO 2009).

the agencies is being considered. What it does for concerned onlookers is display, without doubt, where the priorities for the agencies are; they are not with investors, and they are not with the health of the system.

The fact that the agencies clearly colluded with the concentrated issuers of these ‘exotic’, or more precisely ‘toxic’ financial products is widely recognised[87]. Farlow, in making an excellent analogy that suitably describes the whole situation, states that ‘just as the manufacturers of meat products find clever ways to make the last extruded, and most unprepossessing, bits of offal taste quite palatable, the manufacturers of structured products worked closely with the credit rating agencies to make sure that the bits that got into each rating tranche just about made the grade’. In continuing this notion of a Ponzi-like system, he continues by stating ‘by such a ruse, structured products had on average more favourable ratings than corporate bonds. So long as plenty of buyers were prepared to take the financial products that oozed out of the end – often referred to as collateralised debt obligations - this was an ideal vehicle to pull in more funds to feed the creation and sale of yet more financial products[88]. While the role played by the investors is important and will therefore be covered shortly, the fact still remains that the rating agencies circumvented all of their professional standards in order to participate in this Ponzi-like scheme.

2.3.1.1.1 ‘Stockholm Syndrome’

So whilst it is acknowledged that collusion was taking place between the rating agencies and the issuers, it is appropriate to analyse some of the specific details to add further weight to

[87] Robert Kolb’s work is just one piece that is representative of a wider understanding, see Robert W Kolb *The Financial Crisis of Our Time* (OUP 2010) 177.
[88] Andrew Farlow *Consequences of the Global Financial Crisis* (OUP 2013) 62.

this claim and also provide us with more insight as to the inherent nature of the rating agencies. In order to do this it will be useful to depend on the large post-crisis examination conducted by the US Senate, solely because of its ability to coerce information from the agencies.

In the last chapter we saw how the structure of the securities was created so that different classes of investors could simultaneously invest in them[89]. In fact, the differing levels were absolutely crucial to maintaining the system and garnering the huge levels of investment that the system was devised for. This structuring is called 'subordination', which is just one aspect of what are collectively known as 'credit enhancements'[90]. As was stated earlier, the aim of subordination was to be able to advertise each section of the security as being protected from suffering from losses with relation to the investor's regulatory constraints, so AAA investors were to be protected first from suffering losses whilst the predominantly unregulated Hedge Funds could invest in the lowest (equity) tranche, which contained the possibility of high returns but little protection. The issue for the issuers was that they did not want to spend unnecessarily in order to be as efficient (and profitable) as possible, so it was important that they liaised with the rating agencies to calculate the minimum amount of protection required so that the higher tranches could receive the required ratings to lure the regulatory constrained investors; the rating agencies duly obliged[91]. The same aim can be seen when we understand that the issuers would arrange the product so that the total amount of revenue expected to be garnered from the product was much more than was to be paid out to each tranche, also known as 'over-collateralisation'[92]. The resulting excess was to be factored into the Equity tranche to absorb losses first, which in theory would amount to more protection for the higher tranches. Again, the issuers needed to know the minimum amount of collateral

[89] 1.3.2 *Signalling to the Market* (n 87).
[90] United States Senate (n 81) 251.
[91] ibid.
[92] ibid.

required that would enable the agencies to award the ratings required and leave the excess to be removed from the process.

The extraordinary fees that were being paid by these issuers meant that the emphasis of the Big Three was solely on meeting the requirements of the issuers, with those from the agencies surveyed for the Senate report confirming that there was a strong emphasis 'on relationships with issuers and investment bankers'[93], as opposed to researching new and potentially more accurate and efficient rating approaches. In developing an extraordinarily appropriate analogy, the employees at S&P demonstrated their frustration through internal emails at what they referred to as 'a kind of Stockholm syndrome'. The employee complained that 'they've become so beholden to their top issuers for revenue they have all developed a kind of Stockholm syndrome which they mistakenly tag as Customer Value creation'[94]. The Senate report goes on to confirm this notion by detailing that on a number of occasions the result of an issuer complaining about rating methodologies, criteria, or even rating decisions was that they were often granted exceptions or favourable treatment[95]. There was even documented proof that in some cases where the arranger was not exerting any pressure, the agency still went above and beyond to make the process as cooperative as possible for the issuer[96].

This analysis of the agencies' pandering to the issuers is clearly important in illustrating just where the agencies' priorities actually lie. However, perhaps more important is what they were prepared to do in order to meet the requirements of these issuers. The report declares that some of the factors that fall into this category included rating models that failed to

[93] ibid 274.
[94] ibid 277.
[95] ibid 280.
[96] ibid 284. This section of the report details a deal between UBS and S&P on a 'Vertical CDO' were rating analysts were showing frustration that their managers were going out of their way to accommodate UBS despite little pressure to do so from the bank, and very little cooperation on their behalf. This incident is indicative of their mind-set during this period.

include the relevant mortgage performance data, unclear and highly subjective criteria that was to be used in producing ratings, failing to apply updated rating models to existing rated transactions, and a failure to adequately staff the relevant departments which resulted in a reduction in the effectiveness of rating and surveillance services (at a time when the agencies were recording record revenues)[97]. The point made here regarding the agencies being *aware* of underlying problems in the mortgage market is very important. The report found that even though the agencies were fully aware of the high-risk nature of the loans being issued[98], the lax lending standards and even outright mortgage fraud, they simply continued issuing the ratings that were required to get these products entered into the system. The committee simply concluded that the agencies did this because 'it was not in the short term economic self-interest of either Moody's or S&P to provide accurate credit ratings for high risk RMBS and CDO securities'[99].

This damning evidence continues. Only 6 months prior to the collapse did Moody's begin to factor in the quality of the mortgage originators and servicers; S&P did not factor these elements in at all[100]. We already know through our analysis of the incorporation of the Copula Formula that the agencies had no interest in spending the necessary time to evaluate the soundness of the underlying assets. Again, this evidence points to the requirements of quantity over quality as being the foundation for the agencies' approach. This is also the reason that the necessary re-tests were not conducted.

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[97] ibid 244.
[98] The highest-risk loans were (are) what is known as 'NINJA' loans, which stands for 'No Income No Job or Assets'. For more on this extraordinarily awful approach to finance see Whitney Tilson and Glenn Tongue *More Mortgage Meltdown: 6 Ways to Profit in These Bad Times* (John Wiley & Sons 2009) 12.
[99] United States Senate (n 81) 244. This sort of fraudulent negligence can also be seen in the extraordinary case of Moody's who, in 2007, discovered that a bug in their computer models had generated ratings for products in 2006 which resulted in Aaa ratings, which upon correction should have been up *four notches lower*. The ratings in question were not corrected, see Kolb (n 87) 219.
[100] ibid 252.

Before we move on to analysing some of the actual cases of this negligent and fraudulent approach to conducting their business, one revelation from an S&P employee deserves to be mentioned. In the last chapter under the banner of *The Rating Committee,* we saw how the rating committee is championed by the agencies and their supporters as being the one process that guarantees rating analysts' independence and should inspire confidence from the rating's users that the process is free from bias or external influence. With what we are learning about the ethical conduct of the agencies, the following should come as no surprise:

> Two years earlier, in May 2005, an S&P analyst complaining about a rating decision wrote: 'Chui told me that while the three of us voted "no", in writing, that there were 4 other "yes" votes… [T]his is a great example of how the criteria process is NOT supposed to work. Being out-voted is one thing (and a good thing, in my view), but being out-voted by mystery voters with no "logic-trail" to refer to is another… Again, this is exactly the kind of backroom decision-making that leads to inconsistent criteria, confused analysts, and pissed-off clients'[101].

Rather than inserting their institutional preference into the rating process at the decision stage, which is so obvious that it has the potential of backfiring, the management at S&P cleverly realised that it was not necessary to intervene at such a late and pronounced stage; one can simply interfere and set the parameters at the beginning so that the desired rating will *always* result as a matter of policy. This extraordinary revelation should leave one with very little doubt that the rating agencies did not ever consider the investors' wellbeing in their deliberations. There can also be very little doubt that the agencies did not consider the systemic effects of their detestable actions. One may go one step further and argue that there is very little doubt that any of this has changed as a result of the financial crisis. Whilst this assumption may seem well grounded simply by assessing the reported financial data from the

[101] ibid 294.

Big Three since the financial crisis, it is also supported by the fact that as result of this mountain of documented evidence of negligence and fraud, of which there is much more as we shall see throughout the rest of this chapter, there was very little punishment for their conduct (particularly with regards to the people directing the agencies at that time). What we will see now are some key examples of that 'punishment' which will hopefully allow us to understand whether the leniency displayed is contributing to the continuation of the agencies' contempt for their position.

2.3.1.1.2 Appropriate Punishment?

This notion of 'punishment' is a precarious one. On the one hand there has been punishment administered for crimes committed during the financial crisis, but on the other hand many have argued that the punishment in not enough or not appropriate. To examine these issues this section will look at what has actually been administered in the form of a 'punishment' to attempt to come to a conclusion on whether it has been appropriate. However, to analyse fully the reasons for any perceived misgivings will require much more analysis, particularly with regards to the potential mind-set of those tasked with punishing the offenders, the likes of which will be factored into 2.3.2 *The Pivotal Role of the Guardian – Where the Emphasis Lies for the State*.

In the aftermath of the financial crisis, senior officials within the United States Judiciary were questioning why there had been no convictions for crimes committed during the financial crisis, even though the Senate Subcommittee charged with investigating the collapse referred to the word ‘fraud’ on no less than 157 occasions[102]. In actual fact, at the time of writing there has only been *one* instance of someone being given a custodial sentence for their involvement in the financial crisis, although this figure represents those from the very large and well-known banks; in terms of convictions relating to the financial crisis the Inspector General of the Troubled Asset Relief Program (TARP) confirms that as of 2016 there has been 35 bankers who have been sent to prison for their crimes, albeit from local banks[103]. Yet, this brings us to an important issue which unfortunately cannot be addressed in this thesis; the overwhelming issues attached to the concept of ‘white-collar crime’ dictates that to study a topic that has an entire field devoted to it would not be appropriate[104]. So, whilst this section will not analyse the intricacies involved with prosecuting ‘white-collar criminals’, it will examine the most impactful ‘punishments’ that have been administered against the rating agencies, which are few and far between.

In preparation for the next section that seeks to examine the *actual* role of the state, this section will promote the idea that the agencies are being treated leniently by regulators. This idea is based on two aspects: firstly, that no one from the agencies has been prosecuted for what seems for all intents and purposes consciously fraudulent behaviour; and secondly, that aside from the issues surrounding fining corporate entities rather than prosecuting individuals, the levels of these fines are in no way a deterrent against future fraudulent behaviour, particularly as the agencies have sought to take advantage of their position and

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[102] For Judge Rakoff’s comments see 1.4 *A Snapshot of the Regulatory Framework* (n 113).
[103] See Nicholas Ryder *The Financial Crisis and White Collar Crime: The Perfect Storm?* (Edward Elgar Publishing 2014) 159 for just one account of the conviction of Credit Suisse’s Global Head of Structured Credit Trading Kareem Serageldin, who was sentenced to serve two and a half years in prison. For Christy Goldsmith Romero’s comments on the rate of convictions for bankers more generally see Chris Isidore ‘35 bankers were sent to prison for financial crisis crimes’ [2016] CNN (Apr. 28).
[104] The field that is concerned with the examination of White-Collar crime is extensive and has a variety of perspectives. For just some resources that may be representative see David Weisburd and Elin Waring *White-Collar Crime and Criminal Careers* (CUP 2001); Petter Gottschalk *White-Collar Crime: Detection, Prevention and Strategy in Business Enterprises* (Universal-Publishers 2010). For some perspectives specifically concerned with the financial crisis see Ryder (n 103); Mathieu Deflem *Economic Crisis and Crime* (Emerald Group Publishing 2011); Nicholas Ryder, Umut Turksen, and Sabine Hassler *Fighting Financial Crime in the Global Economic Crisis* (Routledge 2014).

develop extra-curricular type revenue sources that serve to buffer the effect of the fines (Ancillary Service Provision for example). The purpose of this section is to simultaneously examine the ‘punishments’ afforded to the agencies but through that process understand exactly how the agencies acted against the interests of investors for their own gain; every one of the following examples was brought on behalf of an investor who had been wronged by the agencies. So, the section will examine a number of lesser known indictments of the agencies before arriving at what is being championed by the state as a victory for the state and for investors; the case of CalPERS against Standard & Poor’s.

2.3.1.1.2.1 Rhinebridge (and Cheyne Finance) SIVs

So far we have heard about the rating agencies doing all that they could to enable the concentrated issuers to take their RMBSs and CDOs to the marketplace quickly, and with minimal investigation into the assets that were at the heart of these complex financial products. The cases of ‘Rhinebridge’ (and ‘Cheyne Finance’) are representative of a slightly different situation however. These Structured Investment Vehicles (SIVs), amongst a number of others, were in fact *created*, *operated*, and *rated* by the Big Three, as opposed to simply providing a supposedly third-party verification of their creditworthiness[105]. On this basis two institutional investors initiated legal action against Moody’s, S&P, and Morgan Stanley for a variety of charges, including misrepresentation and Breach of Fiduciary Duty. For the purposes of this section only the Rhinebridge case will be assessed, although the Cheyne Finance case is almost identical.

[105] *King County, Washington, and Iowa Student Loan Liquidity Corporation v. IKB Deutsche Industriebank AG, Moody’s Investors Service, Inc., The McGraw Hill Companies, Inc., Fitch, Inc., and Morgan Stanley & Co. Incorporated* [2012] 863 F.Supp.2d 288 (May 4).

Before we understand the intricacies of the case and the conclusion of it, a small detour will be very useful indeed. Although it will also be factored into the next section regarding the State, there is one aspect to the regulations surrounding this level of SIV operation that is demonstrable of why understanding the *actual* is vitally important, rather than being lost and deluded in the pursuit of the *desired*. SIVs are special purpose vehicles that borrow money from investors and then invest in longer-term securities with varying levels of income-producing assets packaged within them. Judge Scheindlin who was presiding over the case surmised that 'the SIV business model resembles that of a bank in that its goal is to earn a spread between its borrowing interest rate and its lending interest rate. Like banks, SIVs have both assets and liabilities'[106].

Earlier, the claim was made that 'behind almost every crisis lays the state'. While this may seem controversial, it was also declared that whether they do this knowingly or not is inconclusive, simply because it is extraordinarily difficult to uncover the underlying rationale for promoting policy changes within a government. The reason why this is important in this case is that the claimants, King County and the Iowa Student Loan Liquidity Corporation, are what is referred to as 'Qualified Institutional Buyers' (QIBs), as was declared by Rule 144A of the Securities Act of 1933 (it should be stated however that the Rule was adopted in 1990, not 1933)[107]. The Rule essentially dictates that only entities that own over $100 million in investable assets may be sold to by brokers or dealers who are operating in accordance with Rule 144A; entities that have over $100 million in investable assets are usually institutional investors. What should be clear here is that the state has funnelled institutional investors, who are socially embedded, into a dishonourable system of finance where *they are the only*

[106] ibid.
[107] *Securities Act of 1933* Pub.L. 73-22, 48 Stat. 74 Rule 144A. The classification is also known as 'Qualified Purchasers' under the *Investment Company Act of 1940* Pub.L. 76-768 2(a)(51)(A). Although part of the Securities Act the Rule was adopted by the SEC in 1990 to 'spur further development of the U.S. private placement market', see William K Sjostrom 'The Birth of Rule 144A Equity Offerings' [2008] 56 UCLA Law Review 410.

available targets. When we understand this, whilst also remembering the despicable practices that were integral to this system of finance, then the state must be held up to be thoroughly examined; this is not just simply a case of a dishonourable financial culture on Wall Street or the City of London.

Getting back to the case, the judge declared that 'the Rating Agencies collaborated with IKB and Morgan Stanley to draft key selling documents, determine which assets the SIV could hold and what structural protections to put in place, and investigate and recommend securities for the SIV's portfolio'[108]; these are not aspects that the agencies declare are part of their operations. Not only did they 'help', they also had the right to veto management changes, veto funding changes, modify its operations and set its investment guidelines (which they did). As the judge concludes, 'the Rating Agencies did not merely provide ratings; rather, they were deeply entrenched in the creation and operation of Rhinebridge'[109].

For our assessment of the *actual* situation between investors and the agencies, and the divergence that exists between what is required and what is delivered, what the judge discussed next in the case is incredibly illustrative of these issues. The SIV issued varying products for investment, like nearly all SIVs do, ranging from CDOs to more focused products like 'Senior Notes'. Senior Notes in this instance was the term used for short-term commercial paper that had maturities of up to 364 days; these notes were given the highest ratings that the agencies could give. In displaying their callous and contrived nature, the agencies 'knew that the Senior Notes could only be offered to QIBs and QPs (Qualified Purchasers)'[110]. Even worse, not only did the agencies recognise this, but the claimants

[108] *King County* (n 105).
[109] ibid.
[110] ibid.

actually informed the agencies that 'they relied on credit ratings to make investment decisions'[111]. A phrase that comes to mind here is 'like lambs to the slaughter'.

With the belief in the rating scales being that AAA-rated entities were extremely unlikely to default on their obligations[112], the AAA ratings given to the Rhinebridge SIV on or about June 27th 2007 was inexplicably downgraded to 'Junk' or 'Non-investment grade' on the 18th and 19th of October 2007. So, in less than four months the SIV was left almost worthless. As a result, the claimants initiated legal action for the purposes of finding the defendants guilty of causes of action for negligence, negligent misrepresentation, breach of fiduciary duty, as well as aiding and abetting with respect to those claims. In the June 7th hearing of the case, the Judge dismissed all the claims except negligent misrepresentation, allowing that claim to proceed. However, as we shall see, the agencies will do anything to not appear in court. The airing of their business and potentially being found guilty as a result prompted them to continue an approach they have always utilised[113], which is to find a resolution that is private in nature by any means necessary. Before the case could be heard the defendants, Moody's, McGraw-Hill and Morgan Stanley settled with the claimants for a total of $225 million

[111] ibid.

[112] As we saw earlier, the agencies themselves viewed the structural finance ratings differently to the corporate ratings (which coincidentally are extraordinarily accurate), although this was not communicated to the investors, an aspect which has been corrected since the crisis, see 1.4 *A Snapshot of the Regulatory Framework* (n 127).

[113] There are a variety of legal (and illegal) approaches that the rating agencies' predecessors established which have been continually utilised by the agencies, including silent settlements, and intimidation (the rating agencies conduct a much more subtle form of intimidation because their victims are now in a much more healthier position to defend themselves than they were in the era of the reporting agencies [contrast the case of *Patterson v Dun*, *King v Patterson*, and *Beardsley v Tappan* against the modern incarnation represented by the case involving Hannover Re]). For a fascinating (re)examination of the approaches utilised by the reporting agencies see Marc Flandreau and Gabriel G Mesevage 'The Untold History of Transparency: Mercantile Agencies, the Law, and the Lawyers (1851-1916)' [2014] Enterprise and Society. For the citations of the cases: (The case report for *Patterson v Dun* has yet to be located by historians, which is extremely unfortunate given its importance to this line of enquiry – it is referenced in other cases however); *King v Patterson*(1887) 49 New Jersey Law Reports 417, 9 A 705; *Beardsley v. Tappan* 5 Blatchf. 498 (1867). With regards to the recent instance of the intimidation of the large reinsurer Hannover Re via unjustified rating downgrades see Alec Klein 'Credit Raters' Power Leads to Abuses, Some Borrowers Say' [2004] Washington Post Nov. 24; Lynn Bai 'On Regulating Conflicts of Interest in the Credit Rating Industry' [2010] 13 New York University Journal of Legislation and Public Policy 253; Paolo Fulghieri, Gunter Strobl and Han Xia 'The Economics of Solicited and Unsolicited Credit Ratings' [2014] 27 The Review of Financial Studies 2.

divided between them, with the details of the settlement remaining private[114]. The agencies did exactly the same thing with the Cheyne Finance case[115].

A rational person may be forgiven for assuming that the agencies, having partaken in the systemic pilfering of investors' resources, would have stopped such detestable practices once the hubris of the era had come to a crashing standstill and their role had been found out, as we have seen so far in this section. However, we shall now see that their manipulative and deceitful practices continued unabated after the height of the Financial Crisis, which may lead to an understanding that the penalties and attack on their reputation were completely ineffective, and most importantly that examining the *nature* of the agencies is imperative, rather than categorising their actions as part of a wider degeneration of ethical standards.

2.3.1.1.2.2 The SEC's 'Cease and Desist' Order against S&P

With the Financial Crisis came the end of the creation of irresponsible mortgages (for the most part), like the NINJA loans we looked at earlier[116]. However, we shall now see why the examination of the agencies and their role in the securitisation process is still important, as the financial crisis brought to an end just one source of the securitisation process, not the ills of the process itself. Between 2010 and 2011, Standard & Poor's had changed its rating methodology of certain financial instruments so that the amount of credit enhancement required to achieve an investable grade was lowered, without publicly declaring the amendment. This is telling, as we have already seen that this aspect of their approach was one

[114] Jeannette Neumann 'Cost of Ratings Suit: $225 Million' [2013] Wall Street Journal.
[115] Stephen Foley 'Standard & Poor's and Moody's settle US subprime lawsuits' [2013] Financial Times.
[116] 2.3.1.1.1 *'Stockholm Syndrome'* (n 98).

of the main issues before the crisis, so clearly the financial crisis had very little effect upon the *practice* of the agencies[117].

In order to provide some context for this claim we will now examine the SEC's recent 'Cease-and-Desist' order against S&P concerning rating certain products. The subject of this cease-and-desist order was S&P's business of providing ratings for 'Conduit/Fusion Commercial Mortgage Backed Securities'[118] (C/F CMBS), products that consist of geographically diversified pools of at least 20 mortgage loans made to unrelated borrowers. Rather than homes, these products contained mortgages for 'Commercial Properties', which for the purpose of the securitisation was divided into five categories: retail, office, multifamily, lodging, and industrial'[119]. The subject of the SEC's investigation was S&P's methodology for calculating 'Debt Service Coverage Ratios' (DSCRs), which is the ratio of the annual net cash flow 'produced by an income-generating property, divided by the annual debt service payment required under the mortgage loans', with the ultimate aim being to provide a measure of the property's ability to cover debt service payments[120].

The SEC note that S&P's market position for rating these types of products had declined following the financial crisis, which had the knock-on effect of subduing the issuance of new CMBS products. However, the Big Three are reactionary, and serve to capitalise upon trends so that they can extract as much profit as possible, even if this means relegating any ethical standard to do so. When issuers increased their CMBS output in 2010, S&P's CMBS Group

[117] What is meant by this is that the financial crisis affected the revenues of the agencies from structured finance deals simply because the levels of issuance of structured finance products naturally dropped in response to the crisis. The SEC note that the issuance of structured finance products bounced back from 2010 onwards (albeit at lower levels than witness pre-crisis), with the difference being that the underlying assets were of a slightly different nature. This was noted in the press briefing by the SEC concerning the cease-and-desist order against S&P, which this section will be relying on, see Securities and Exchange Commission *Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933 and Sections 15E (d) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order* [2015] Release No. 9705; 74104, File No. 3-16348.
[118] ibid.
[119] ibid.
[120] ibid.

decided that the fact the company's market share had not grown in sync with the level of issuance was solely due to 'conservatism of the firm's criteria' in rating CMBS products[121]. This deplorable willingness to sacrifice quality and accuracy to garner profit and not lose market share to competitors, who S&P naturally assume are also willing to lose any standards, is the clearest picture of all that shows that the agencies cannot be trusted to hold anyone's interests dear other than their own.

In a lot of these cases the fraud perpetrated by the agencies is clear, but not so completely obvious that calls for individual prosecution would have any considerable weight. The case with agencies circumventing their rating process by setting rating standards that were favourable to issuers *before* the decision process is a good example of appropriating negligence, but pinning individual fraud charges would be very difficult, unfortunately. However, this case of the cease-and-desist order is entirely different. DSCRs have the effect of lowering the amount of credit enhancement required to obtain a top rating, which is a factor we have analysed throughout this section and is clearly an aspect that would garner business from issuers. In late 2010, S&P changed its methodology for calculated DSCRs to realise this exact dynamic for issuers. Between February and July of 2011, S&P published eight CF CMBS reports that 'failed to describe its changed methodology'. Not only did they not declare the change to interested investors, *they included DSCRs that were calculated using the prior methodology*[122] (which had the effect of portraying conservativeness that no longer existed). This was not simply an error, because on at least four out of the eight occasions the CMBS group communicated the details of the revised DSCR model to the *issuers* of the products, which not only gives the issuers a distinct advantage but also proves collusion between the agency and the issuers. For this the agency received just over $7 million for the rating of six transactions.

[121] ibid.
[122] ibid (emphasis added).

To compound this Faustian relationship, the Senior Management of S&P responded to investor questions about low Credit Enhancement levels by stating that the ratings were 'consistent with S&P's rating definitions', with the SEC confirming that 'these publications did not inform investors of the effect of the change in methodology on required CE levels'[123]. In a perfect environment, one free from lobbying influence, the political protection for white-collar criminals and a narrow societal definition of 'crime', this fact of conscious misrepresentation alone would lead to the indictment of the senior management of S&P for fraud, along with the leading figures of the CMBS division[124]. But this is not a perfect environment, which is sadly and brutally confirmed by the leniency of their punishment for this attack upon investors.

The SEC found the agency guilty of no less than four serious violations of major financial legislation. The punishment for this extensive crime was an overall fine of $42 million (rising to $80 million) and a 12 month suspension from the business of providing ratings on any CF CMBS transactions. The SEC did however allow the agency to publicly deny the findings of the SEC's investigation and admit no fault. As we have seen already, and will continue to see, the agencies are determined to settle any case away from public scrutiny and are insistent

[123] ibid.

[124] It should be mentioned here that legal aspects such as the issues with the lifting of the 'corporate veil' would most likely come in to play in this scenario, although the US and the UK both have measures which would allow them to prosecute corporate officers, rather than just the company itself. For the U.K.'s own assessment of its capability under law to prosecute corporate officers for financial fraud see Crown Prosecution Service 'Corporate Prosecutions' [2015]. The US DoJ also has a dedicated division for Fraud, see The United States Department of Justice 'Fraud Section (FRD)' [2015]. Whilst the capability to prosecute corporate officers, and in certain circumstances major shareholders for negligent/fraudulent behaviour exists, it is very rare that the judiciary in a given state will do so for a myriad of reasons. As there is clearly no appetite for prosecuting the officers of the CRAs and also that this thesis is not overtly calling for such prosecutions, it would not be appropriate to envelop such an analysis here because to effectively cover the main issues would take volumes, at the very least. For just some analyses that investigate these issues further see Julie Cassidy *Concise Corporations Law* (Federation Press 2006); Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry B Hansmann, Gérard Hertig, and Klaus J Hopt *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2009); Angela Schneeman *Law of Corporations and Other Business Organisation* (Cengage Learning 2009) §7.6; Eilis Ferran and Look C Ho *Principles of Corporate Finance Law* (OUP 2014) Ch. 2.

upon denying any wrongdoing, primarily for the purposes of reducing any future legal action for the same offence.

This issue of leniency and inappropriate punishment is one that will be considered later in Chapter 3 *Why the Agencies Transgress and What Allows Them to Do It,* mainly because it is the by-product of certain aspects that are enforcing this divergence between what is *desired* and what is *actually* occurring. There are a number of instances around the world where rating agencies are being found guilty of fraudulent behaviour against investors and are being prosecuted as a result. In Australia, the Courts have found the agencies (predominantly S&P) to be guilty of 'deceptive and misleading conduct', awarding a claimant $18.8 million in the process[125]. In Europe, the European Markets and Securities Authority has issued its first monetary punishment since coming into force after the financial crisis, fining DBRS $33,360 for failing to comply with record keeping requirements (concluding that the agency had 'acted negligently')[126]. Whilst these legal actions are welcome, it is clear that fines of $42 or $18 million are not going to influence the decision making process of an entity that records revenues in the billions of dollars. In response to the $18 million fine in Australia S&P spokesman Richard Noonan characterised the agency's view on such matters: 'It is bad policy to enforce a legal duty against a party like S&P, which has no relationship with investors who use rating opinions, yet impose no responsibility on those investors to conduct their own due diligence'[127]. Whilst Noonan's claim of the agency having *no* relationship at all with investors is obviously not correct as we should now be aware, his claim regarding investor responsibility will certainly need to be considered before we end this section regarding the *actual* situation between the agencies and the investor. However, before we can

[125] This was the result of action initiated by Bathurst Regional Council (that spanned a number of cases against a number of entities). For more see *Bathurst Regional Council v. Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200; *ABN AMRO Bank NV v. Bathurst Regional Council* [2014] FCAFC 65; David Fickling 'S&P, RBS Lose Appeal of Ruling Australian Towns Misled' [2014] Bloomberg (June. 6).
[126] Huw Jones 'EU watchdog imposes its first fine on rating agency DBRS' [2015] Reuters (June. 29).
[127] Fickling (n 125).

do that there is one series of events that needs to addressed, as it resulted in the largest fine ever to be imposed upon a rating agency. The concept of fining agencies may be distasteful to some, but the breach the billion-dollar barrier signifies the level of fraud/negligence that was found by prosecutors.

2.3.1.1.2.3 The Case of CalPERS

In 2009 the California Public Employees' Retirement System (CalPERS) filed a complaint against Moody's, S&P and Fitch on the grounds of negligent misrepresentation and negligent interference with prospective economic advantage[128]. The claimant initiated the actions based on the rating agencies' granting of their highest ratings to three SIVs (Cheyne Finance, Stanfield Victoria Funding, and Sigma Finance), which the claimant invested in in 2006. Having invested in the AAA-rated SIVs in 2006, the three SIVs subsequently defaulted on their payment obligations in 2007 and 2008, resulting in the loss of around $1 billion for CalPERS alone.

There is very little need to analyse the intricacies of this fraud by the agencies because the cases of Cheyne, Stanfield Victoria and Sigma are identical to the Rhinebridge case we assessed earlier in this section. The difference with the CalPERS case is that whilst the investor pursued its own lawsuit, the Department of Justice took action (based upon the CalPERS situation and the complaints of over 20 states for similar offences). The introduction of such a powerful entity fundamentally altered the rules of engagement for the rating agencies. Whilst they had used their tried-and-tested legal approach to emerge

[128] Complaint for Negligent Misrepresentation under Common Law & California Civil Code §§ 1709 & 1710 & Negligent Interference with Prospective Economic Advantage at 23, Cal. Pub. Employees' Ret. Sys. v. Moody's Corp. (and others), No. CGC-09-490241.

relatively unscathed from the previous legal actions taken against them, they would surely not be able to intimidate or manipulate the United States Department of Justice in a similar manner. This is a rational conclusion to come to, although in assisting our understanding of the unique nature of the agencies, the fact that S&P decided to fight back against the DoJ is representative of their attitude and their inherent nature.

CalPERS settled with Fitch first. The terms of the settlement are fascinating, and hint at the *actual* situation of the rating industry being a duopoly, rather than an oligopoly. Under the terms of the settlement Fitch handed over confidential documents to CalPERS that would be crucial for the investor to continue to pursue its claims against Moody's and S&P; no money changed hands[129]. While it may admittedly be a stretch to claim that as members of an oligopoly the agencies would protect each other, Fitch's willingness to absolve themselves of potential financial punishment by providing the investor with crucial and unobtainable information is extraordinarily telling of the dynamics of the industry today.

Meanwhile, the DoJ had picked up on the ascent of the CalPERS case through the courts and on this occasion took the lead for CalPERS, for itself as the representative of the Federal Government, and for 20 states against Standard & Poor's. After initial settlement talks broke down, the DoJ sought to sue S&P for a record $5 billion on the grounds of 'defrauding investors'. In response, and in what can only be described as terribly advised or extraordinarily egotistical approach, the rating agency accused the DoJ of pursuing the lawsuit purely because the firm had downgraded the United States' sovereign rating shortly before. This naturally riled the Attorney General Eric Holder who stated that punishing the agency was 'important to me' and dismissed the allegation as 'utter nonsense'[130]. This incredible approach hints at a number of potential actualities concerning the ratings industry

[129] Dale Kasler 'CalPERS cleared to sure ratings agencies' [2014] Sacramento Bee (Sept. 15).
[130] *A Primer on the Credit Rating Domain* (n 5). See also Ryder (n 103).

at present. Firstly, it signifies that the agencies believe that their conduct is acceptable and does not warrant punishment. Secondly, it perhaps details their arrogance as a private party to go against the state (and arguably the most powerful state in the world), particularly in the manner that they did. Lastly it demonstrates their belief, founded upon continued success, that irrespective of their conduct they can find a way out of being punished by a variety of methods. However, in this instance these factors resulted in the largest fine ever conferred upon a rating agency (albeit not at the initial $5 billion that was pursued).

Through extensive dialogue the DoJ and S&P finally agreed on a settlement package of $1.375 billion[131]. In a settlement of the private lawsuit between CalPERS and S&P the agency paid $125 million[132], thus taking the total outlay on the 3rd of February 2015 to $1.5 billion for defrauding investors. The settlement with the DoJ was split between the Federal Government ($687.5 million), and the 20 states ($687.5 million split according to an agreement between the states). The DoJ also insisted that the agency would not be able to do what it was used to doing in denying the facts. The agency admitted misrepresenting key information to investors, being aware of delinquent loans and not informing the public, and that decisions were not taken because of the potentially negative effect upon their business with paying issuers. Additionally, S&P acknowledged that ‘the voluminous discovery provided to S&P by the United States in the litigation does not support their allegation that the United States’ complaint was filed in retaliation for S&P’s 2011 decisions on the credit rating of the United States’, with the agency formally retracting the claim from the

[131] United States Department of Justice ‘Justice Department and State Partners Secure $1.375 Billion Settlement with S&P for Defrauding Investors in the Lead Up to the Financial Crisis’ [2015].
[132] CalPERS ‘CalPERS to Recover More than $300 Million from Standard & Poor’s in Investment Ratings Settlements’ [2015].

litigation[133]. CalPERS have taken action against other fraudulent actors and have been able to retrieve almost $900 million for its efforts.

Some have suggested that the decision to prosecute S&P and not Moody's, who acted in exactly the same manner, is proof that the S&P litigation was a retaliation for their lowering of the United States' credit rating, as Moody's did not lower the rating[134]. Time will only tell whether this assumption is correct, although it is widely believed that there is enough evidence to indict Moody's in a similar fashion and also that there is the appetite to do so[135]. For our analysis of the *actual* relationship between the agency and the investor, these examples of Rhinebridge, Cheyne, and other SIVs, together with the SEC's cease-and-desist order against S&P (and a long list of other smaller examples), provide us with more than enough evidence to confidently claim that in actual fact the agencies are operating *against* the investors, especially when there are substantial amounts of profit to be made from working with highly unstable financial products. This claim may be viewed as controversial, or at the least considered to be relying on extreme examples of the agencies' operations. However, it is precisely such extreme examples that demonstrate the true position of the agencies.

2.3.1.1.2.4 Are Investors Completely Innocent?

Before this section concludes, the claims made by the S&P spokesman Richard Noonan deserve to be assessed. The focus of this thesis is predominantly on the agencies for their conduct and the state for its mentality towards that conduct. However, as this section is

133 United States Department of Justice (n 131).
134 The Wall Street Journal 'A Poor Standard of Justice' [2015] (Feb. 8).
135 A range of respected news outlets are simultaneously suggesting that the DoJ's indictment of Moody's for the same offences is imminent, for the original story see Timothy W Martin 'Justice Department investigating Moody's Investors Service' [2015] Wall Street Journal (Feb. 1).

concerned with the *actual* situation between the agencies and the investors, the analysis would not be complete without turning our attention towards the conduct of the investors. Is it correct to claim that investors (particularly institutional investors) were irresponsible in relying so heavily upon the ratings of the agencies? Should institutional investors take much more care when investing, as their resources are predominantly from the public and have a systemic importance? These types of questions clearly signify the reality that the investors naturally played a part in the system; the important question is whether they took these risks knowingly and are now looking for a scapegoat to facilitate the recuperation of their losses, or whether they were forced into a system whereby those who forced them into it did not adequately check the safety of the system first.

Andrew Farlow has suggested that the *actual* situation is closer to the first of these two scenarios. He argues that the securitisation system that dominated the pre-crisis financial landscape was an 'agreeable way to make money' and as such 'investors never asked awkward questions about the underlying collateral'[136]. Whilst some have argued that it is more the case of investors believing in the purpose and function of the CRAs, and subsequently suffering the consequences for this misplaced understanding[137], Farlow is unequivocal in his stance that in actual fact investors made huge returns on these fundamentally risky endeavours, and they took this risk because they knew that when the defaults came they would not be punished and be financially supported by the state; Farlow labels this scenario 'Heads they had won; tails they would win'[138].

Apart from alluding to the Too-Big-To-Fail issue that is dominating the modern marketplace, Farlow also makes the point that Governments reaped huge financial rewards in short-term

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[136] Farlow (n 88) 62.
[137] Thomas Clarke 'Corporate governance causes of the global financial crisis' in William Sub, Jim Stewart , and David Pollard *Corporate Governance and the Global Financial Crisis: International Perspectives* (CUP 2011) 39.
[138] Farlow (n 88) 62.

taxes that were related to the securitisation system (in addition to reaping the rewards that come with a market experiencing a large boom). He is arguably correct in claiming that the investors did not ask enough questions when investing the money of millions upon millions of people[139]. He is also arguably correct in claiming that the investors knew that the government, on behalf of taxpaying citizens, would rescue them if they all partook in the system. But, what these views do not consider is the parameters for their actions. Yes they could have done more but the situation regarding the legal funnelling of institutional investors into an unregulated financial system is deplorable. The actions of Government Sponsored Enterprises like Fannie Mae and Freddie Mac, in pursuing institutional investors and making the terms of their investment almost irresistible, is surely more important. The conscious relegation of laws that had protected the United States, and arguably the world, from systemic financial collapse for over 70 years cannot be ignored.

When assessing the conduct of the issuer, of the rating agencies, and of the investor, it becomes quickly apparent that underneath all of the factors that are often discussed (i.e. industry dynamics, organisational structure) lies the state, and its approach is pivotal in decided the navigation of the eras. For this reason we shall now assess what the *actual* situation is for the state. We saw in 2.2.3 *The Desired Situation for the State* that its aim should be to promote and maintain systemic balance, as its position as the guardian for public health dictates that it must foster balance within the economic realm (given the centrality of the market in modern life). In this sense then there are two deductions that can be made: either the state simply failed in its mandate in 2007/8, in which case we could confidently say that the financial crisis could be categorised as the largest failure of the state (as an ideal) in

[139] This sentiment is not exclusive to the rating scenario. Sergakis notes that with respect to proxy advisors, investors are, in the same manner to users of credit ratings, extremely over-reliant upon proxy advisors. Again, this is because of the perceived supporting of these third-party actors by regulators, see Konstantinos Sergakis 'Proxy Advisory Firms Under ESMA's Microscope: A Perfectible Regulatory Approach?' [2014] 25 International Company and Commercial Law Review 4.

the modern era; or they produced the situation for a variety of reasons, which means that what we understand its mandate to be, i.e. the *desired* situation, does not exist and we should recalibrate our focus accordingly.

Earlier it was stated that it is extraordinarily difficult to know if certain policies were enacted with an aim in mind, which makes proving the culpability of the state almost impossible (at least beyond any reasonable doubt). However, this should not dissuade one from assessing the actions of the state from within such parameters, as to refuse to do so would limit the analysis and distort any potential conclusions that this thesis may come to. The reform proposal that dominates this thesis is practicable, but controversial. It is not controversial in the sense that it is not deserved, because as we are seeing the conduct of the agencies has been, and continues to be quite frankly appalling. It is controversial in the sense that the likelihood of it being, at the very least, considered, is solely dependent upon the state's inclination to affect lasting change in a field where societal safety is often spoke about but rarely established. The abusing of their position by the agencies to defraud investors is clear, so it is entirely reasonable to suggest that the *desired* situation for investors (i.e. independence and transparency) is unattainable and for the most part a fallacy; but, is it really the case that the *desired* situation for the state is also unattainable and a fallacy? We shall now investigate whether this is indeed the case, although it must be noted before that investigation begins that the consequences of that understanding being confirmed are truly dire.

2.3.2 The Pivotal Role of the Guardian – Where the Emphasis Lies for the State

It would be prudent to operate on the basis that the financial system, within the modern context, is certainly part of the public domain[140]. With the financial system being central within modern society, the state is charged with supervising an arena that contains organised and concentrated power, whilst having to balance that against the interests of dispersed and diverse entities such as citizens. When we also consider that the globalised nature of the modern world means that financial policies can, and often do, affect other countries outside of one's own jurisdiction, then the precarious nature of the state's role is clear.

However, this role is accompanied by the defining power of being able to direct the progression of the market, and therefore modern society. In this section we shall see how the state, in its many forms, has arguably acted against their *desired* role as imagined by the general public and society moreover (or at the very least what the understanding of the quintessential role of the state is). Again, it is very important to state that whether this is done consciously or not cannot be accurately determined, but the facts can be established to build a picture of whether the approach of the state can be predicted. We shall see shortly how the incredible events of the financial crisis were directly facilitated by state intervention, and how, essentially, such expansion in the market and the inevitable decline that follows *can only* be created by the state; private actors simply do not have the power to control the direction of the marketplace as a whole. Peter Swan argues that understanding this dynamic can fundamentally alter one's philosophical parameters. For example, the financial crisis is widely held to be one of the largest *failures* of the state in modern times, however for Swan 'it was not a failure of regulatory policy, *but the very success of regulatory policy by*

[140] Geoffrey Underhill 'The public good versus private interests and the global financial and monetary system' in Daniel Drache *The Market or the Public Domain: Redrawing the Line* (Routledge 2005) 280.

successive administrations and Congress that had created the subprime crisis'[141]. This incredible understanding means that whilst it is right to focus on the conduct of rating agencies, banks, investors, and all the other culpable parties in the financial crisis, it is erroneous to focus *just* on them because if Swan's understanding is to be accepted then they were all *actively encouraged* to do what they did.

The opposing argument may be that the state sought to increase productivity and economic output by loosening the financial constraints that had been in place since the Great Depression, and that this innocent motive had been abused by dishonourable parties. However, the sheer amount of evidence that exists from recent history that proves that banks and rating agencies *will always* attempt to maximise their potential returns at the cost of reducing their ethical and moral standpoint renders that opposing argument simply invalid; their conduct was to be expected. So, whilst it would be imprudent to accept Swan's argument in full, it is appropriate to continue in the vein of not rejecting such a controversial but fitting idea. It is in this theoretical light that this section will seek to assess how different the *actual* actions of the state are to that which is *desired* of them, from the perspective of societal balance at least. Doing so will serve the aim of being able to predict the theoretical likelihood of the reform proposal of this thesis being established.

2.3.2.1 Setting the Scene

The power of the state to direct the market, and therefore society, manifests itself through the ability to regulate the capabilities of market actors (through legislation and financial regulations). If the state deems it appropriate to ban a practice outright then that practice

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[141] Peter L Swan 'The Global Crisis and Its Origins' in Robert W Kolb *Lessons from the Financial Crisis: Causes, Consequences, and Our Economic Future* (John Wiley & Sons 2010) 54 (emphasis added).

simply cannot continue, irrespective of the influence of the targets (we saw this with the forced separation of Commercial and Investment Banks in the 1930s – a regulatory approach that is vitally important for this thesis). Alternatively, if the state deems it appropriate to facilitate the proliferation of certain business practices, then usually that area is opened for business and tends to generate incredible activity due to the fresh potential for sizeable returns; this process is known simply as deregulation.

In charting the actions of the state in the lead up to the crisis we can examine the role it plays in setting the direction of the marketplace, with the aim being to reveal patterns that can illuminate us as to their potential motives for taking particular actions. It is worth noting before we continue that Neil Barofsky, who was the Special (United States Treasury Department) Inspector General charged with overseeing the Troubled Assets Relief Program (SIGTARP), declared that 'I was to learn while at SIGTARP that "adopting a narrative" was a tried-and-true tactic in Washington: define the status quo as a success, and ignore all evidence that suggests otherwise'[142]. This method needs to be incorporated into our understanding of the possible methods the state may use to justify their systemically-concerned decisions because should the evidence point to this being a reality, that the state actively promotes a narrative that will help it achieve a set goal irrespective of the evidence, then it will have a huge impact on our assessment of what parties the state seeks to embolden at the cost of others.

The Senate Subcommittee report that has proven to be useful to our analysis so far will be useful again, as it details how in the mid-1990s the pieces were put in place for the systemic escalation of risk to begin. Damon Silvers, in describing these pieces with regards to the mortgage market, states that 'the pieces were in place in a deregulated mortgage market for a

[142] Neil Barofsky *Bailout: An Inside Account of How Washington Abandoned Main Street While Rescuing Wall Street* (Simon and Schuster 2012) 8.

wholesale shift from 30-year fixed mortgages to short-term mortgages. Securitisation, largely unregulated mortgage companies driven by executive pay linked to their stock prices, and regulators who did not believe in regulating at the Federal Reserve were all in place'[143]. Furthermore, the ability for large banking institutions to partake in the system was determined by key pieces of legislation, which was a crucial factor in dictating the potential size of the bubble that would inevitably burst.

To briefly provide some context we have to go back to the turn of the 20th Century. At this time the burgeoning United States was dominated by just a few expansive banking houses, chief amongst which was the empire controlled by J. P. Morgan[144]. However, to counter the influence of this financial oligarchy unofficially led by Morgan, the state (under the auspices of the administration of President Coolidge) enacted the McFadden Act of 1927[145], with the aim of rebalancing the national banking market so that large overpowering banking conglomerates were not unfairly dominating the State-wide banking organisations within each state. This prohibition on interstate banking, however, did not have the desired effect because the large banking institutions had the distinct advantage of being able to combine the resource-generating commercial banking entities with the speculative (and potentially very profitable) investment banking entities, a system also known as 'Universal Banking'.

In 1929, however, the situation changed for large banking houses, and changed dramatically. Their role in the Wall Street Crash, which was an important factor but by no means the only

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143 Damon Silvers 'Deregulation and the New Financial Architecture' in Martin H Wolfson and Gerald A Epstein *The Handbook of the Political Economy of Financial Crises* (OUP USA 2013) 439.

144 John Pierpont Morgan's influence spread the length of the United States and even further afield. As a result there is an extensive range of literature that can provide details on the man and his legacy. For just a few resources see Daniel Alef *J.P. Morgan: America's Greatest Banker* (Titans of Fortune Publishing 2009); Ron Chernow *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (Grove/Atlantic, Inc. 2010); Steven H Gittelman *J.P. Morgan and the Transportation Kings: The Titanic and Other Disasters* (University Press of America 2012).

145 *An Act to Further Amend the National Banking Laws and the Federal Reserve Act (McFadden Act)* Pub.L. 69-639 H.R. 2 (1927).

one[146], turned public opinion against them to such an extent that politicians sought to take impactful action against them. The politicians and legislators wanted to reduce their speculative capability, with the intention of fostering systemic balance, and also to make the infamously opaque banking institutions as transparent as possible; up unto this point J.P. Morgan *had never* issued a financial report for examination[147]. To digress for one brief moment, it is worthwhile noting the famous words of Machiavelli: 'Whoever wishes to foresee the future must consult the past; for human events ever resemble those of preceding times. This arises from the fact that they are produced by men who ever have been, and ever shall be, animated by the same passions, and thus they necessarily have the same results'[148]. This sentiment was clearly not in the minds of legislators and politicians in the mid-1990s when they sought to dismantle these New Deal-era legislative principles as we shall see very shortly.

To continue, in the New Deal era of the United States, the state, under the auspices of the Roosevelt administration, sought to finally reduce the overwhelming presence of the largest

[146] Interestingly for us the dynamics within the banking industry were not the only factor that instigated the era-defining reforms. In response to the fraudulent and obscure offerings of securities that were at the heart of the Wall Street Crash, regulators (primarily the Comptroller of the Currency) incorporated the *credit rating agencies* to officially provide verification for the safety of securities being offered; the Comptroller forced certain investors to only invest in securities the agencies deemed safe. This is commonly referred to as the start of the induction of the agencies into the economy, although that understanding is misleading, as economic historians have detailed that the agencies were considered central, and where also given legal status, years before the actions of the Comptroller in 1931. For more on the Comptroller's actions see 1.4 *A Snapshot of the Regulatory Framework* (n 101). For why the understanding developed by Partnoy primarily is not accurate see Marc Flandreau and Joanna K Slawatyniec 'Understanding Rating Addiction: US Courts and the Origins of Rating Agencies' Regulatory Licence (1900-1940)' [2013] 20 Financial History Review 3. For Partnoy's establishment of the view that 1931 signifies the creation of the agencies' 'regulatory licence' see Frank Partnoy 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers' in Yasuyuki Fuchita and Robert E Litan *Financial Gatekeepers: Can They Protect Investors?* (Brookings Institution Press 2007); Partnoy (n 69). For just one assessment into the fraudulent aspects of securities offerings before the Wall Street Crash in 1929 see Frank Partnoy *The Match King: Ivar Kreuger and the Financial Scandal of the Century* (Profile Books 2010).

[147] Charles R Geisst *Wall Street: A History* (OUP 1997) 201.

[148] Mark T Hebner *Index Funds: The 12-step Program for Active Investors* (IFA Publishing 2006).

banking entities[149]. In enacting the Banking Act of 1933[150], more commonly referred to as the Glass-Steagall Act after its Senatorial sponsors and certain important sections within the Act, the state had brought an end to 'universal banking' and forced the previously almighty banking establishments to choose between registering as a commercial bank or an investment bank[151]. The state also sought to remove the redeemer-status that J.P. Morgan and his affiliates had donned after the Panic of 1907 intervention, arguably unenthusiastically[152], by introducing deposit insurance which fundamentally (although not entirely) reduced the risk of national 'runs' on banking institutions[153]. This concept of facing the challenge of regulating *against* powerful entities is an extraordinarily important one to this thesis, and arguably should be vital to every other normative analysis of the financial sector. This incredible era initiated over 70 years of financial balance (for the most part), which has come to be referred to as the 'Quiet Period'. Gary Gorton argues that this Quiet Period shows that 'properly designed bank regulations can prevent financial crises for a significant period of time'[154].

However, in adapting Gorton's analysis and combining with it Swan's analysis from earlier, perhaps it could be stated that properly designed *deregulation* can also generate similar levels of success, albeit within in a purely alternative context. Irrespective of the heated debate that surrounds this issue of the relevancy of deregulation, the seemingly coordinated series of legislative events can help us to understand further the potential causes of the crisis. The

[149] Geisst (n 147) 230. Perhaps the best demonstration of their *influence*, in excess of their obvious power emanating from being leading bankers, can be seen when assessing the foundations of the modern-day financial lynchpin that is the Federal Reserve. For more on the fascinating insight into J.P. Morgan, J.D. Rockefeller and the Executives of Kuhn, Loeb essentially creating the Federal Reserve see Alexander Tabarrok 'The Separation of Commercial and Investment Banking: The Morgans vs. The Rockefellers' [1998] 1 The Quarterly Journal of Austrian Economics 1. For more general resources analysing the foundations of the Federal Reserve see Gabriel Kolko *The Triumph of Conservatism* (Quadrangle Books 1963); Murray N Rothbard 'The Federal Reserve as a Cartelisation Device: The Early Years 1913-1930' in Barry N Siegel *Money in Crisis* (Ballinger 1984).
[150] *The Banking Act of 1933* Pub.L. 73-66, 48 Stat. 162.
[151] Randall S Kroszner and Raghuram G Rajan 'Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933' [1994] 84 The American Economic Review 4 814.
[152] R G Donaldson 'Financing Banking Crises: Lessons from the panic of 1907' [1993] 31 Journal of Monetary Economics 71.
[153] Geisst (n 147) 230. This was also the reason for the creation of the Federal Reserve. For more on the truly fascinating beginnings of the Federal Reserve see Tabarrok (n 149) 1.
[154] Gary Gorton *Misunderstanding Financial Crises: Why We Don't See Them Coming* (OUP USA 2012) 4.

Senate Subcommittee, in continuing its examination across the eras suggests that up until the mid-1990s the New Deal era statutes were having the intended effect: 'U.S. banking consisted primarily of thousands of modest-sized banks tied to local communities… this broad-based approach meant that when a bank suffered losses, the United States could quickly close its doors, protect its depositors, and avoid significant damage to the U.S. banking system or economy'[155]. However, 1994 was the beginning of the end for the Quiet Period. In that year the state, under the Clinton administration, introduced the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994[156], with the result being that banks could now begin to establish branches across the country and also buy other banks across the country. Supporters of the Act argued at the time that it would 'allow banks to become more efficient as they grew bigger, reducing costs, lowering loan rates, and accelerating economic growth'[157]. We know now with hindsight that this was a short-sighted and dangerous analysis, although if we ignore the pleasantries of affording these supporters the protection of hindsight for just one moment, it is worth noting that it is these sorts of misguided and naive sentiments that add support to dangerous movements (and this doesn't just apply to financial regulation – and we shall see further evidence of this phenomena next in 2.3.2.2 *Deregulation – A False Diagnosis*); the responsibility that comes with being a reputable commentator should inhibit one's prevalence for placing trust in untrustworthy sectors (the Machiavellian quote from earlier is again very much applicable here).

In 1987, the same year that Alan Greenspan assumed the Chairmanship of the Federal Reserve, the 'Fed' began to allow banks to establish affiliates that dealt in short-term commercial paper securities, although they established the restriction that these dealings

[155] United States Senate (n 81) 15.
[156] *Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994* Pub.L. 103-328.
[157] Hersh Shefrin and Meir Statman 'Behavioural Finance in the Financial Crisis: Market Efficiency, Minsky, and Keynes' in Alan S Blinder, Andrew W Loh and Robert M Solow *Rethinking the Financial Crisis* (Russell Sage Foundation 2013) 124.

could not contribute more than 5 percent of the bank holding company's revenues[158]. But, in 1997, which was the same year the Riegle-Neal Act was to be fully implemented, the Federal Reserve (still under the stewardship of Greenspan) voted to raise the limitation to 25 percent. The Federal Reserve also allowed the Citicorp-Travelers merger which opened the floodgates for excessively large conglomerates to reappear. Furthermore, the state formally repealed the Glass-Steagall Act of 1933 with the Gramm-Leach-Bliley Act of 1999[159], which essentially 'eliminated the Glass-Steagall prohibition on banks engaging in proprietary trading and exempted investment bank holding companies from direct federal regulation'[160].

The deregulatory phase was completed with the enactment of the Commodity Futures Modernisation Act of 2000[161], which 'barred federal regulation of swaps and the trillion-dollar swap markets, and which allowed U.S. banks, broker-dealers, and other financial institutions to develop, market, and trade these unregulated financial products'[162]. These Acts were all either developed or supported by now-infamous figures within the financial world. Senator Gramm, who was a leading proponent of the deregulatory legislation that bore his name in 1999, was a key instigator in the CFMA 2000 Act for ensuring that the SEC was to have no oversight over swaps (something which he insists to this day was the correct thing to do incidentally)[163]. U.S. Treasury Secretary Larry Summers was instrumental in rushing through the legislation whilst the 'extraordinary bipartisan consensus' had been formed[164]. Robert Rubin, who preceded Summers in leading the Treasury was the key advocate of leaving the derivatives market unregulated, overriding the Commodity Futures Trading Commission Chairman Brooksley Born in the process to lead a bipartisan effort with the

158 Silvers (n 143) 439.
159 *The Gramm-Leach-Bliley (Financial Services Modernisation) Act of 1999* Pub.L. 106-102, 113 Stat. 1338.
160 United States Senate (n 81) 16.
161 *The Commodity Futures Modernisation Act of 2000* H.R. 4577.
162 United States Senate (n 81) 16.
163 Eric Lipton and Stephen Labaton 'Deregulator Looks Back, Unswayed' [2008] The New York Times (Nov. 16).
164 United States Department of the Treasury *Remarks of Treasury Secretary Lawrence H Summers to the Securities Industry Association* (Treasury Press Centre Nov.9 2000).

aforementioned Senator Gramm to ensure that the derivatives market was open for business; Rubin subsequently joined Citigroup who would go on to be one of the biggest recipients of TARP funds[165]. This is what is referred to as the 'revolving door' and will be covered in more detail in 2.3.2.3 *Mechanistic Importance*.

This concerted phase of deregulation, developed by prominent members of the financial elite, is of course extremely worrying. Silvers makes the note that if the New Deal era statutes were designed to smash the House of Morgan, the deregulatory phase in the late 1990s was designed to rebuild it. In fact, once the dust had settled from the turbulent period of 2007 and 2008, there were only four giant banking institutions left standing in the United States: J.P. Morgan Chase, Citigroup, Bank of America, and Wells Fargo[166]. The lessons learned by 'FDR' in the midst of the Great Depression were conveniently forgotten. Claims such as those from James K Galbraith, that this version of the state represents 'the predator state', are particularly hard to argue against. Galbraith defines the predator state as one that 'systematically turned regulation over to the industries to be regulated, and not just to them but to their lobbies, which tended to represent the most aggressively anti-government, antiregulation, and antistabilisation aspects of each industry'[167]. Yet there are those that do argue against this understanding, and they argue their case vehemently.

[165] Silvers (n 143) 442.
[166] ibid. Silvers notes that together these institutions control over 60% of the assets of all US bank holding companies.
[167] James K Galbraith 'The Roots of the Crisis and How to Bring It to a Close' in Robert W Kolb *Lessons from the Financial Crisis: Causes, Consequences, and Our Economic Future* (John Wiley & Sons 2010) 38.

2.3.2.2 Deregulation – A False Diagnosis

There is a line of reasoning, advanced by a number of prominent scholars and politicians, that suggests the argument that deregulation was a key cause of the crisis is, to put it bluntly, 'dead wrong'[168]. The protagonists of this belief are predominantly strongly pro-market, and believe that governmental intervention should only occur when the potential effects of failure are truly large in scale[169]. So, rather than castigating the state for deregulating the marketplace, this point of view castigates them for *determining* the abhorrent practices witnessed in the creation of the Financial Crisis through regulation rather than deregulation. As we shall now see, the leading protagonists suggest that all of those entities criticised in the wake of the collapse, from investment banks and insurers to rating agencies and mortgage brokers, were simply adhering to policies that the state had conjured up years before the crisis began.

Charles Calomiris is particularly active in promoting this notion of deregulation being a positive element rather than a negative one. Calomiris argues that the deregulation narrative adopted in the wake of the crisis 'made no sense', mostly because the involvement by banks in the subprime mortgage market and within mortgage securitisation moreover was 'in no way affected by the deregulation of the last two decades'[170]. Furthermore, he argues that instead of threatening the security of the economy, deregulation *in fact* 'cushioned the financial system's adjustment to the subprime shock by making banks more diversified and by allowing troubled investment banks to become stabilised by becoming, or being acquired

[168] Charles W Calomiris 'The Subprime Turmoil: What's Old, What's New, and What's Next' [2009] 2 Journal of Structured Finance 37.
[169] ibid 32.
[170] Charles W Calomiris 'Origins of the Subprime Crisis' in Asli Demirgüç-Kunt, Douglas D Evanoff, and George G Kaufman *The International Financial Crisis: Have the Rules of Finance Changed?* (World Scientific 2011) 88.

by, commercial banks'[171]. In what is at best a rather 'unique' understanding of events he continues by suggesting that in opposition to previous crises, where 'shocks have not been mitigated by the raising of capital by financial institutions in the wake of losses', the response of the U.S. financial system to such a devastating collapse was an *improvement* which emanated from deregulation, consolidation, and globalisation[172]. This 'improvement', i.e. the appropriation of over half a trillion dollars of tax-payers money to prop up a system that has been officially labelled as systemically fraudulent, is according to Calomiris 'appropriate, and allows monetary policy to be "surgical" and more flexible'[173]. He also concludes that, in what he sees as a positive element, the acquisitions of Bear Sterns and Merrill Lynch by J.P. Morgan Chase and Bank of America respectively would not have been possible without the repealing of Glass-Steagall.

There is a slightly more palatable argument advanced by Jeffrey Friedman and Wladimir Kraus, who contest that looking solely at the role deregulation played *directly* within the securitisation process has to lead to the conclusion that this argument is deficient. The technical understanding that no bank got into trouble because of a securities affiliate is indeed true. Also, the understanding that the banks that suffered losses did so because they held low quality mortgages which was an activity that was always permitted by Glass-Steagall is also arguably true[174]. However, even though Friedman and Krauss call for us to look beyond 'narrow intellectual horizons'[175], which is obviously a welcome call, both they and Calomiris do not follow that advice. The deregulatory phase may have not had an absolutely direct impact upon the securitisation system like Calomiris explains, but the systemic escalation of profits and risk that resulted from widespread deregulation did have a direct effect upon the

[171] ibid.
[172] Calomiris (n 168) 7.
[173] ibid.
[174] Jeffrey Friedman and Wladimir Kraus *Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation* (University of Pennsylvania Press 2011) 445.
[175] ibid 28.

potential of the inevitable collapse enveloping the global community. As we shall see after examining the next main component of this school of thought, not looking beyond such narrow intellectual horizons has perhaps made their understandings particularly dangerous with regards to capitalising upon the financial crisis to promote stark realities.

Calomiris blames 'regulatory failure', particularly with respect to the Government-Sponsored Enterprises (GSEs) like Fannie Mae and Freddie Mac and also prudential banking regulation, as the key contributor to the Financial Crisis. This sentiment is echoed by another prominent protagonist, Peter Wallison. Wallison, who was a prominent Republican under President Reagan, was the leading dissenting opinion in the Majority Report of the Financial Crisis Inquiry Commission. For Wallison the fault lies with the government, although not for the deregulatory measures it imposed years before the crisis but for its housing policies instead, which is more or less the same argument as Calomiris' (they rely upon the same research as we shall see shortly).

He ultimately argues that the government-induced growth of the subprime mortgage market inevitably resulted in a decline of underwriting practices[176]. Through the Housing and Community Developing Act of 1992[177] and the re-enforcement of the Community Reinvestment Act of 1977[178] (in 1995), Wallison argues that Non-Traditional Mortgages (NTMs) became hot property and the overwhelming presence of the two GSEs meant that underwriting practices had to deteriorate in order to meet the legal requirement to hold such mortgages. The *stated* aim of the government was to increase the availability of loans for mortgages to middle- to low-income applicants by changing the standards for applicability

[176] Peter J Wallison 'Dissenting Statement' in Phil Angelides *Financial Crisis Inquiry Report* (DIANE Publishing 2011) 451.
[177] *The Housing and Community Development Act of 1992* H.R. 5334
[178] *The Community Reinvestment Act of 1977* Pub.L. 95-128, 91 Stat. 1147.

i.e. the down-payment percentage required was reduced to just 5% and the applicant only had to have a satisfactory credit history spanning the previous *12 months*[179].

Wallison cites these figures, and the fact that only Lehman Brothers ranked in the top 5 of MBS issuers at the height of the market in 2005 as being the proof for the claim that banking deregulation was not to blame for the crisis; the rest of the top five was made up of other subprime issuers *like Fannie Mae and Freddie Mac*. This ultimately led Wallison to conclude that 'it would be more accurate to say that Wall Street followed Fannie and Freddie into subprime lending rather than vice versa'[180]. This version of events advanced by Wallison details a false system, whereby the laws forced GSEs, subprime lenders and banks into funnelling more and more funds into the MBS market so that instead of defaults occurring earlier and the crisis coming to view, the incessant pumping of funds into increasingly lower quality loans meant that those who would normally be delinquent borrowers were able to refinance and prolong the system.

This argument is completely rational, and is supported by the facts of the securitisation system and the effects of the legislation that was passed. However, in attributing blame, Wallison seeks to pardon a wide range of market actors and simply focus on the government, which is an extraordinary mistake. He argues that the Commission's report is wrong for criticising 'firms, regulators, corporate executives, risk managers and rating agency analysts' because the information about the composition of the mortgage market '*was simply not known when the bubble began to inflate*'[181]. This sentiment is particularly distasteful in light of the fraudulent behaviour by those market actors Wallison pardons. However, there is one aspect to Wallison's understandings that raises enough suspicion to warrant an alternative viewpoint; the GSEs were not completely regulated and only shared their financial

[179] Wallison (n 176) 454.
[180] ibid 463.
[181] ibid 466 (emphasis added).

information with regulators voluntarily. This is important because, in essence, their mandate was to guarantee loans for NTMs on the basis of meeting the government's quotas and regulations, not for profit. This perception, according to Wallison, led market participants to believe that the loans held by the GSEs were 'prime' loans, as their quasi-governmental status had always resulted in their conservatism in making financial decisions. What had actually happened was in order to meet the demands of the state the GSEs had subverted such policies and were actually holding millions more NTMs than the market knew (because they did not have to disclose their records)[182]. The result of this was the contagion witnessed in the privately created MBS market, which subsequently spread across all mortgages because mortgages are all related by house prices. So, the shock at the losses in the private MBS market was amplified to a spectacular degree because the market then realised that Fannie and Freddie held much more NTMs than they had initially realised. This was why in September 2008 the placing of both Fannie Mae and Freddie Mac into conservatorship signalled the commencement of the actual 'crisis'.

So this understanding places the blame squarely at the feet of the U.S. government. It is difficult to argue against this perception because the facts of the crisis allude to it being the correct evaluation. However, to suggest that market actors who are relied upon to *know* certain elements of the economy better than anyone else (i.e. credit rating agencies and securities analysts) simply could not have known is irresponsible. A key aspect in responsible economics is to analyse trends and not just accept figures at face value, which is something Wallison seems to overlook; it was not impossible for rating agencies and market analysts to have known that the bubble was not based on solid foundations. The key issue here is that whilst it was not impossible, it was extremely *profitable* to accept figures at face value and as we have seen already in this chapter: 'money triumphed over ethics'.

[182] ibid.

Wallison's viewpoints are perhaps narrow, but they are at least critical. The viewpoint held by Calomiris however is particularly different. Whilst it is prudent to remain objective, it is important to use Calomiris' views (and the school of thought he represents) as an example of the dangers in misappropriating the reverence for scholarly commentary. This school of thought that suggests the suspension of accepted regulatory principles and the appropriation of over half-a-trillion dollars of tax-payer money to pump into irresponsible institutions is not only acceptable but should be praised, is exceptionally dangerous. It provides the intellectual support for a societal shift that possibly may affect the direction of human history. The events of the financial crisis set an extraordinarily bad precedent; it was no ordinary 'crash'. When we align this fact to the understanding that very few have been prosecuted, and the leading figures of the process have become significantly wealthier than they already were, then the school of thought should be understood as contributing to the advancement of that agenda. Calomiris stated in 2009 that 'those of us who argued in the 1980s that nationwide branching would allow commercial banks to serve as platforms for universal banks with large relationship economies of scope can now say *we told you so*… Bank of America, J.P. Morgan Chase, and Citibank have all weathered the financial storm'[183]. Through the Troubled Asset Relief Program the three institutions received $115 billion of tax-payer money. Those that can say we *told you so* must accept their share of responsibility in contributing to the largest and most widespread financial collapse on record.

Calomiris and Wallison pay particular attention to one source of research. Edward Pinto, who was a former executive vice president and chief credit officer for Fannie Mae until he was dismissed 'without reason' in the late 1980s[184], is a particularly staunch critic of the GSEs and their involvement in the financial crisis, probably best characterised by his many works

[183] Calomiris (n 168) 43 (emphasis added).
[184] James R Hagerty *The Fateful History of Fannie Mae: New Deal Birth to Mortgage Crisis Fall* (The History Press 2012) 203.

on behalf of the American Enterprise Institute[185] and his many testimonies to official hearings in the wake of the crash. The issue is however that Pinto's research is doubted in the same manner that his motives are, which whilst this thesis makes no statement on Pinto's integrity, other scholars have[186]. Wallison himself ultimately admits that this line of reasoning is 'difficult to prove'[187]. Whilst it is fine and arguably beneficial to the discipline that theories are not discounted just because they are not 'popular', the effects of Wallison's and Calomiris' incorporation of Pinto's understandings are troubling. Unfortunately, whilst Wallison's dissent in the enquiry was widely criticised and was labelled as such, Calomiris' work continues to garner a following.

Coming to a unanimous conclusion is particularly difficult. It is difficult because one's understanding of this area comes not just by assessing the facts, but also by how the facts relate to one's wider perception of society. For example, the deregulation detailed in this section cannot be disputed; there were a number of legislative actions that took place within a particularly concentrated period of time that definitively illustrates a conscious period of deregulation. The issue with that however comes when we ask 'what was the purpose?' At first glance the divide seems straightforward. One argument is that it was to liberate constrained markets and increase efficiency by returning to a financial system centred on universal banking. We can also add to this that the state made a genuine attempt to increase the availability of mortgages to people who usually would not be afforded such an opportunity. Both of these endeavours are just and righteous from the perspective of societal health. But, the other argument centres on the fact that the financial crisis was the largest and most extensive financial collapse on record and irrevocably altered power structures. Perhaps

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185 Edward J Pinto 'Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study' [2011] American Enterprise Institute. Pinto has a number of other related works which form aspects of the scholarly output of the AEI, for more see the American Enterprise Institute.
186 Paul Krugman 'Evil > Stupid' [2011] New York Times Blog (July 15); Christopher Payne *The Consumer, Credit and Neoliberalism: Governing the Modern Economy* (Routledge 2012) 169; Oonagh McDonald *Fannie Mae and Freddie Mac: Turning the American Dream into a Nightmare* (A&C Black 2013) 146.
187 Payne (n 186).

more importantly, it has made the public safety net an *expectation* rather than an extraordinary solution, which alters the rules of our society completely. This argument would lead one to believe that the motives of the state and of the market actors who gained the most from the pre-crisis system were not genuine. This argument has to lead to the conclusion that these entities do not operate in the name of societal balance, which is a stark and chilling proclamation.

This divergence between perspectives is fascinating. Now that we have assessed the role the state played (and will inevitably continue to do so) in directing the economy and therefore society, it will be useful to briefly assess the relationship between the state and the rating agencies. If we are to believe that the state acts genuinely in attempting to promote economic efficiency, then what role do the rating agencies play in the state's plans? Alternatively, if the state seeks to disrupt societal balance (for a variety of reasons), then how will the rating agencies fit into that agenda? What we will see, which will be a familiar understanding after the analyses conducted so far, is that rating agencies are crucial in facilitating the plans of the state, whatever they may be. The outsourcing of certain functions to specialist agencies allows the state to focus fully on directing the economy, whilst also maintaining a distance so that aspects such as attaching authority do not come into the reckoning. Unfortunately for those that seek to find definitive answers, these elements fit into both categories of the state that seeks societal balance and health, and the state that seeks to preserve elite power structures.

2.3.2.3 Mechanistic Importance

This section will be very brief for two reasons. Firstly, the importance of the agencies to the state in carrying out its mandate, whatever that may be, has already been established throughout the thesis. We have seen how the agencies are important in allowing the state to form a regulatory framework for a smaller cost than if it were to do it itself, and we have also seen how the agencies fit into the relationships between each market actor, which serves to make them almost indispensable within currently accepted understandings of the economy and how it should function. Secondly, to describe in detail why they are so important would take away from the analysis that follows directly after this section. The reasons why agencies are considered to be so important are exactly the reasons why there is such a divergence between what is *desired* and what *actually* occurs. Aspects such as the need to decipher and navigate through the purposefully created complexity that defines the modern marketplace is just one reason for why the state seemingly depends upon the rating agencies, despite its claims of reducing rating dependency in the wake of the crisis.

It is becoming apparent that there are two extremes that describe the role of the 'state': the first version consisting of the state aiming to protect the public through making genuine attempts to foster responsible economic growth, and the second that is chiefly concerned with providing a supportive environment to financial elites so that they can make as much money as possible without bearing the cost of that inherently-excessive quest. The former of these versions is safe; it is comforting to believe in and most importantly it contains answers. If we understand that the state was simply exploited by greedy and immoral market actors, then should the state incorporate this knowledge into its regulatory approach we should, theoretically, be free from further financial disasters. But, there is very little evidence for this being the reality. There is however an abundance of evidence that suggests the state acted predominantly in the interests of market actors who stood to profit immensely from the pre-crisis system, which brings us to ask why they would do such a thing.

It is admittedly a digression but arguably it is an important one because understanding the *motive* of the state may help us understand how and why it utilises the rating agencies in the manner that it does. It must be declared immediately that there is simply not enough space in this thesis to accommodate an appropriate analysis of what is known as 'Capture Theory'. However, some cursory definitions, when combined with a closer look at just one small element, may suffice for our requirements. 'Capture' in the context of regulation can be broadly defined by a regulatory agency or officer acting for the benefit of a party that is compensating it in some way, in opposition to its stated mandate (which usually is to *protect* a given entity that is at risk i.e. investors or the general public). A good example of capture from the financial crisis can be found in the statement of former Chairperson of the Federal Deposit Insurance Corporation (FDIC) Sheila Bair, who in an extraordinary exposé of the world of banking regulation detailed how the problem with regards to regulators and Citicorp (as the primary example) was not just a cosy relationship between them 'but a problem of regulatory capture, in which the (Office of the Comptroller of the Currency) OCC, Office of Thrift Supervision (OTS), and the Fed all saw themselves as *advocates* for the banking industry, rather than as regulators of the industry'[188]. This one example is indicative of capture, whereby the captured agency or agencies go against their mandate and actively work *for* the party that has captured it; it is so easily forgotten that they are public servants.

Capture theories cover a wide range of aspects, and advance a number of methods and reasons for how and why agencies (and therefore states in some cases) can become captured

[188] Adam J Levitin 'The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay' [2014] 127 Harvard Law Review 23 (emphasis added).

by private interests[189]. One reason that may supplement our analysis is known as the 'revolving door' theory[190]. The 'revolving door', which signifies the moving between different strategically-important positions within the field of finance (it can apply to other fields of course), increases the potential for success for the lobbying efforts of big business. Sriramesh notes that 'lobbyists and public relations consultants in the U.S. often use personal influence to conduct their public relations activities… these former officials rely on the contacts they made during their tenure in government service to help their clients'[191]. This is clearly an issue and the fact that the whole lobbying system is not as transparent as it perhaps should be compounds the potential for regulatory capture to occur.

The biggest issue here is one of influence, and it is common knowledge that the leading figures in the agencies concerned with financial stability (The Treasury, The Federal Reserve etc.) had predominantly moved to the agencies from the leading entities on Wall Street, so much so that the government was termed 'Government Sachs' by the press for the amount of ex-Goldman Sachs employees who were in influential positions in the government when the

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[189] For just some of the key works on the capturing of the legislative process see Mancur Olson *The Logic of Collective Action: Public Goods and the Theory of Groups* (Schocken Books 1968); George J Stigler 'The Theory of Economic Regulation' [1971] 2 Bell Journal of Economics and Management Science 3; Sam Peltzman 'Toward a More General Theory of Regulation' [1976] 19 Journal of Law and Economics 211; Charles E Lindblom *Politics and Markets: The World's Political-Economic Systems* (Basic Books 1977); Theodore J Lowi *The End of Liberalism* (WW Norton & Company 1979). For a deeper analysis of the concept see Jon Hanson and David Yosifon 'The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture' [2003] 152 University of Pennsylvania Law Review 173. For the arguments against the presence and effects of regulatory capture see Michael A Crew and Charles K Rowley 'Toward a public choice theory of monopoly regulation' [1988] 57 Public Choice 1; Michael E Levine and Jennifer L Forrence 'Regulatory Capture, Public Interest, and the Public Agenda: Towards a Synthesis' [1990] 6 Journal of Law, Economics and Organisation; Daniel Carpenter 'Confidence Games: How Does Regulation Constitute Markets?' in Edward Balleisen and David Moss *Towards a New Theory of Regulation* (CUP 2009); Lawrence G Baxter 'Essay: "Capture" in Financial Regulation: Can We Channel It Toward the Common Good?' [2011] 21 Cornell Journal of Law and Public Policy 177.

[190] For a representative analysis of the 'revolving door' theory see Andrew Baker 'Restraining regulatory capture? Anglo-America, crisis politics and trajectories of change in global financial governance' [2010] 86 International Affairs 3.

[191] Krishnamurthy Sriramesh 'Power, Distance and Public Relations: An Ethnographic Study of Southern Indian Organisations' in Hugh M Culbertson and Ni Chen *International Public Relations: A Comparative Analysis* (Routledge 2013) 186.

crisis hit[192]. If we are to accept this is as the true version of events (and one cannot deny that is true, it is just a matter if one believes it has an effect), then the *potential* effect it may have, at the very least, deserves maximum attention. If regulatory leaders are sympathetic, if not absolutely supportive to their former employers' concerns (a lot of them return to the industry once their term finishes), and legislative leaders are being systematically lobbied by organised and connected parties, then it is rational to suggest that the state functions for business predominantly, and not for the public who they represent in a democracy. There will be much more on this topic in the next Chapter, but for now there is an important question to be asked before we can move on: if the state operates for business, then what role do the rating agencies play in assisting the state in its business-friendly endeavour?

If we look back on what has been established already with regards to the function of the rating agencies, and analyse it from the point of view of helping the state to promote and protect the interests of big business, then the centrality of the agencies to that cause quickly becomes apparent. Credit ratings allow the state to separate investors so that only the truly large, influential, and resource-rich investors can partake in schemes that stand to generate the most profit for a handful of organisations. Rating Agencies also govern which organisations (issuers) will be allowed to partake in such schemes by administering the required ratings for entry to a specific marketplace. While this admittedly sounds conspiratorial, we have already learned how the rating policies of the top agencies in the lead-up to the crisis became *highly* subjective, which alone means this understanding is not entirely baseless.

Again it must be stated that such conclusions will be measured on one's general and personal understandings of the economy and society moreover. Whilst the belief that the state operates

[192] Helen Deresky and Elizabeth Christopher *International Management: Managing Cultural Diversity* (Pearson Higher Education AU 2011) 53.

for business and against the public may be too adversarial for some, it can at least be stated that enough evidence exists to suggest that it *may* be the case. The existence of the possibility alone should cause suspicion and force people to apply their critical faculties when assessing the power relations within our market-centric society. What can also be said, perhaps with much more authority, is that a clear divergence between what is *desired* and what is *actually* the case exists throughout the relationships in which the ratings industry plays an important part. Irrespective of the view that someone may have on the role of the state, it must be advanced universally that it has a considerable duty to protect its citizens; so this is a *desired* quality. Investors can reasonably expect that rating agencies do not *actively* operate against them, as prior to 2010 the state forced them to deal with the rating agencies *exclusively*; this is a *desired* quality. But, the *actual* reality is arguably completely different, as this section has endeavoured to detail. What we need to know now is *why*? What are the key reasons that underpin and perpetuate this divergence? Finding the answer to these questions will have a direct impact on our ability to predict the potential for the reform proposal to be adopted and forms the purpose of the following Chapter.

2.4 Conclusion

The stated aim of this chapter was to explore what underpins the roles of the issuer, the investor, and the state and essentially examine them in relation to the credit rating industry and the events of the Financial Crisis (and beyond). The reason why it was important to take this approach was because the aftermath of the Financial Crisis has revealed one very important truth; the regulations that followed did not curb the successes or the intolerable culture of the rating industry. In fact, there is an argument that this culture has been further embedded *because* of the post-crisis regulations, in that the dynamics surrounding the industry have been altered so that it is now even more difficult to apportion blame if and when the ratings industry is at the heart of another financial disaster[193]. If we operate on the understanding that the regulations failed to alter the dynamics surrounding the ratings industry to any considerable degree, then the question of why this was so is clearly relevant to ask.

In this chapter the foundation was set to answer that very question; in the next chapter we shall examine the *reasons* for this divergence between the *desired* and the *actual*, but in order to do so this descriptive chapter was required. So, with that mandate in mind the first task was to establish the *desired*, in furtherance of the analysis in Chapter 1, so that we could begin to investigate whether this *actual vs. desired* framework could be a reasoned approach to answering the all-important question regarding the effectiveness of the post-crisis regulations.

We began by analysing the relationship between the positions of the issuer, the investor, and the state, as one may reasonably expect them to act. The chapter opened with an analysis of the issuer, and what became clear was that at the heart of the relationship was the concept of 'trust', in that the issuer was utilising the trust that investors have in rating agencies, and that the agencies themselves were trusting the issuers to disclose accurate information that would cultivate the trust of the investor (a clearly cyclical arrangement). However, our analysis so far unearths a number of issues that should lead one to believe that this concept of 'trust' is a fallacy when applied to this area. For decades institutional investors have been *forced* to consider the ratings of NRSROs, which negates any argument of 'reputational capital' as

[193] The intricacies of the regulatory response to the crisis, and the issues with it, will be covered in more detail in Chapter 4 *Tried and Failed: An Assessment of the Legislative and Regulatory Response to the Industry's Role in the Financial Crisis*.

being an effective regulator[194]. This also has the effect of reducing the need for rating agencies to consider the effect its conduct has upon the investors, which was clearly demonstrated with the willingness to accommodate the needs of the paying issuers to the detriment of investors.

In a similar vein we saw how the investor requires the rating agency to be impartial in its operations, so that the investor (of all classes) can factor reliable information into their investment decisions. To determine this impartiality, the investors require transparency so that they can know for themselves whether or not a particular agency is a viable source of information. Yet, the *actual* circumstances are particularly pervasive in this regard. For example, the events that led to the SEC issuing a cease-and-desist order against S&P[195] show that the agencies are more than willing to disseminate *false* information in order to garner business from the paying issuers. Clearly then, even in the post-crisis regulatory phase the transparency required by investors cannot be guaranteed.

Following on from this analysis of the requirements of the investor, we saw how the state, from the philosophic perspective of being predominantly concerned with protecting and advancing the public interest, requires the rating industry to form part of its arsenal that is designed to foster economic security, whilst also lowering the cost for the state. Yet, the *actual* situation shows us that this act of outsourcing cost the state (and therefore the public) an incredible amount of money, and arguably altered the dynamics of this market-centric society so that the state will continue to foot the bill for future phases of unrepentant greed. Even more interestingly however was the analysis of the motivation of the state, and in particular the notion that the financial collapse was actually a victory for governmental

[194] See (n 79) for issues regarding 'reputational capital'.
[195] See 2.3.1.1.2.2 *The SEC's 'Cease-and-Desist' Order against S&P*.

policies rather than a failure[196]. The assessment of the concerted efforts of the state to strip away the protection that had been in place for over 70 years is an extraordinarily damning assessment, although as we saw how one interprets this assessment is extremely divisive.

Ultimately it is contested here that this divergence between what is *desired* and what is *actually* the case is real and is pervasive. The number of instances where the ratings industry operated against what may be termed as ‘the public interest’, and more tellingly against what they themselves argue is their role, is truly staggering. Whether it is brazenly operating against investors who control the savings of the vast majority of the developed world, or whether it is going against the mandate that was given to it to lessen the possibility of a systemic failure, the ratings industry has acted in its own interest throughout. Perhaps what is truly desired is that the ratings industry should consider others, in some limited form, it its approach to business.

However, the rating industry has shown no appetite to do this since it received NRSRO status in the early 1970s. It actually showed no appetite to do so before then, but the fact that they were dependent upon investors (subscribers) for their income prohibited the agencies from fully indulging in their self-preservation. Today there is no such prohibition. This notion is what this thesis argues has to be incorporated into any future regulatory proposal. Rather than hoping or anticipating that the agencies will act in a certain way, we should heed the words of Machiavelli[197] and examine their *actual* performance and the motivations that underpinned that performance; there is simply no justification for believing that the agencies will act in a socially responsible manner.

Whilst eradicating the *actual* entirely, in terms of conflicts of interests stemming from remuneration structures or the ‘revolving door’ is undoubtedly desirable, it is almost

[196] Swan (n 141).
[197] (n 148).

impossible. There are simply too many factors at play that would inhibit such a reality coming to fruition. However, rather than seeking to eradicate the *actual* i.e. the oligopolistic structure of the industry, or the issuer-pays remuneration system, it is argued here that we acknowledge the *actual* as much as possible. What is meant by this is that *accepting* certain truths about the ratings industry, i.e. that issuers must pay for the ratings otherwise nobody else will because of the ‘free-rider’ problem, will allow us all to focus upon the reality of the situation rather than focusing on attaining the *desired* without any real substance, i.e. calling for increased competition for an industry defined by its oligopolistic structure to appease widespread condemnation of the agencies’ performance. Whilst some elements of the *actual* cannot be changed, like the fortified position of an industry that is 175 years old or the need for third-party analysis in the bond market, there are elements that can be changed if we view the process of reform in the right way; it is not unreasonable to constrain the activities of such a fundamentally important sector of society, irrespective of their private status. Dictating that rating agencies cannot exploit their position by offering non-rating services is perfectly rational and represents an element of the *actual* which can so easily be changed given there is an appetite to do so. In the next chapter we shall see how the divergence between the desired and the *actual* came to be, and how it continues. This will be a very important endeavour if we are to demonstrate clearly that what is required is a different way of looking at rating agency reform; we must understand intently and acknowledge the reasons for this divergence if we are to reduce the potential dangers that rating agencies pose to society.

Chapter 3 – Why the Agencies Transgress and What Allows Them to Do It

3.1 Introduction

In the conclusion of Chapter 2 *The Divergence Between the Actual and the Desired*, it was declared that only by acknowledging the *actual* can we make truly impactful reforms. The divergence between the *actual* and the *desired* is such that predominantly focusing on the *desired* results only in an increase of that divergence. So, to attempt to understand the divergence more, so that we can begin to position a reform proposal as effectively as possible, it will now be important to examine what allows the agencies to transgress in the way that they do, and also why they do so. To do that this chapter will focus upon three major elements to the credit rating industry: its oligopolistic structure; its issuer-pays remuneration system (adopted widely within the industry); and finally the reliance on the agencies exhibited by regulators.

These three elements are all crucial components of the divergence. What is also important to note is that they operate interdependently; one cannot survive on its own in the long term. Yet, these elements are not 'explanations' for the divergence; they are in fact 'components' that allow for the agencies to transgress and therefore create the divergence that was established in the previous chapter. The three elements are all predicated upon the existence of a self-interested ethos, and as such are all manifestations of that ethos. Although it may seem obvious that a private company would have a self-interested ethos, it is the gatekeeping position that the agencies exploit which dictates that a *wholly* self-interested ethos is undesirable. This self-interested ethos essentially dictates the conduct of the agencies and the actions that they take, so assessing their adoption of the issuer-pays model, or the manoeuvers that the agencies make to preserve their oligopolistic industry structure, i.e. buying out new competitors, can only be truly understood when one considers their underlying ethos.

However, perhaps the most obvious issue here is that it is very difficult indeed to *prove* an entity's ethos indefinitely, so with that in mind the only option available is to conduct a lengthy historical assessment to reveal patterns in the industry's conduct. Such a research project that would present a genealogical review of the actions of the leading agencies from its origination to the present day would be beneficial for the field, but for now such an assessment is beyond the limitations of this thesis. Nevertheless, the literature concerned with the history of the industry reveals an ethos that, up until the late 1960s, was solely concerned with surviving via defence, which manifested itself in smear campaigns of those the agencies had wronged, and in concerted legal campaigns to absolutely remove any liability[1]. The developments of the late 1960s/early 1970s, as we shall see in this chapter, heralded a new ethos; this ethos was to be concerned with survival via attack, in the form of maximisation. The agencies, in taking absolute advantage of their position *and* the environment that they operated in, embarked upon a quest to secure as much income as was possible and this quest continues to this day.

This thesis is essentially an examination of that ethos, by way of an examination of one particular manifestation of that ethos (ancillary service provision). The thesis' call for the need to reduce the agencies' capability to absorb punishments, in order to reduce their enthusiasm for putting society in danger for their own gain, is based upon the foundation of that wealth-maximising and socially-irresponsible ethos being understood; the last chapter clearly revealed this ethos in showing the agencies' disregard for anyone else, and now this chapter will show how that ethos manifests itself and allows for the agencies to diverge from what they ought to be doing.

[1] The legal campaigns adopted by the agencies was discussed earlier, see 2.3.1.1.2.1 *Rhinebridge (and Cheyne Finance) SIVs* (n 93). In addition to this, see Scott Sandage's excellent account of the appalling treatment of John Beardsley, Scott A Sandage *Born Losers: A History of Failure in America* (Harvard University Press 2006).

To do this the chapter will begin by assessing one of the key components that allow the agencies to transgress, and that is the oligopolistic structure of their industry. Oligopolies vary by way of the norms that form the parameters, so depending on the product that is being sold the members of the oligopoly may choose to compete against each other in a seemingly open (but actually constrained) market i.e. Airline companies, or may choose to form a cartel or monopolistic structure because their product is finite and is linked to external factors like national position i.e. OPEC[2]. As for the rating industry, the oligopoly consists of three major firms as we know, and the market share between Standard & Poor's and Moody's affects the internal dynamics of the oligopoly further still. The external factors that affect the rating oligopoly, the perceived need for their output and the effect it has upon society for example, results in a unique situation (although it is rare that two oligopolistic structures are alike).

The chapter will therefore begin by assessing the oligopolistic structure of the ratings industry, which will then be followed by an examination of what keeps the oligopolistic structure in place. Even though the ratings industry has been within the confines of an oligopolistic structure since 1851, and has experienced times when they were legitimately facing extinction[3], we shall see that the structure is what is referred to as a 'natural oligopoly' in that the end-users, investors, would be disadvantaged by increased competition. In light of this we shall also see how many alternatives that have been advanced, ranging from the

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[2] William A McEachern *Economics: A Contemporary Introduction* (Cengage Learning 2011) 236 'At one extreme, oligopolists may try to coordinate their behaviour so they act collectively as a single monopolist, forming a cartel, such as OPEC. At the other extreme, oligopolists may compete so fiercely that price wars erupt, such as those that break out among airlines…'.

[3] Partnoy notes that 'the rating agencies were struggling when John Moody died in 1958. By the 1960s, the rating agencies employed only half-a-dozen analysts each, and generated revenues primarily from the sale of published research reports' see Frank Partnoy 'The Paradox of Credit Ratings' in Richard M Levich, Giovanni Majnoni, and Carmen Reinhart *Ratings, Rating Agencies and the Global Financial System* (Kluwer 2002) 70. Wilson and Fabozzi note that in relation to Standard & Poor's 'Paul Babson gained control and removed Poor's from Bankruptcy. In 1940, it sold its manual subscription list to Moody's Investors Service. However, still having a difficult time, it merged with Standard Statistics in 1941, see Richard S Wilson and Frank J Fabozzi *Corporate Bonds: Structures & Analysis* (Frank J Fabozzi Associates 1996) 211. Abdelal succinctly puts this period of hardship down to the economic health of the period: 'the late 1940s, 1950s, and 1960s were happier to both issuers and holders of securities, but for the rating agencies the times were perhaps too good: no one seemed to default', Rawi Abdelal *Capital Rules: The Construction of Global Finance* (Harvard University Press 2007) 167.

complete removal of the agencies[4] to a non-profit based supplementation, are rarely practical given the *actual* dynamics of the ratings arena; the ultimate conclusion will be that the success or failure of the arena is solely dictated by the investors, which is an important point to consider when formulating reform proposals.

In order to understand this modern ethos better it will be important to assess the reasons for the issuer-pays model's adoption, which in hindsight represented the change in ethos from survival via defence to survival via attack. Within the literature there are three hypotheses that are commonly advanced to explain why the model was adopted: the impact of the collapse of Penn Central in 1970; the threat faced by technological advancements in the late 1960s; and to a lesser extent the change in conditions facilitated by the collapse of the Bretton Woods monetary system in 1971. The first two will be assessed in turn, with passing reference to the third, although there will be an intense assessment of the Penn Central hypothesis because it is the most commonly advanced hypothesis; the question is however whether the hypothesis includes all the information, or whether it produces a rationale that distorts the direction of responsibility?

Finally the Chapter will look at the issue of regulatory reliance. It is consistently proposed in the literature that the decision by the SEC in 1975 to incorporate the agencies into its regulations was the turning point that allowed the agencies to contribute so heavily to the degeneration of the economy almost thirty years later. To assess the validity of this claim the Chapter will first seek to examine the concept of the regulatory incorporation of the agencies *in its entirety*; choosing just one era to represent an industry that is 175 years old has the potential to be incredibly misleading. The results of this complete analysis reveal an aspect

[4] An example of a proposal that calls for the removal of the rating agencies, at least as they exist now, is in Emilios Avgouleas *Governance of Global Financial Markets: The Law, The Economics, The Politics* (CUP 2012) 394-447. An example of transferring the role of producing financial indicators to market-based measures (i.e. credit spreads) can be found in Frank Partnoy 'How and Why Credit Rating Agencies Are Not Like Other Gatekeepers' in Yasuyuki Fuchita and Robert E Litan *Financial Gatekeepers: Can They Protect Investors?* (Brookings Institution Press 2007).

that is consistent with the findings from the oligopolistic section; it is the investors that dictate the future of the industry – regulators merely react to market dynamics with respects to the field of credit ratings. Yet, the act of incorporating the agencies into the regulatory framework, without having any real control over the agencies, was a particularly naïve error that gave further impetus to the agencies in allowing them to transgress.

Assessing the 'ethos' of the rating agencies is very difficult, primarily because understanding it is simple. In essence, the agencies we see today have learned from their ancestors and recognise that at any moment the tide could turn against them and their existence could be threatened. We have already seen, and will continue to see, how these agencies protected themselves by seeking to limit their liability and used the law to protect them from harm. However, a genuine threat to their existence in the 1960s meant that those measures would not be enough, and to really survive they would have to *exploit* their position, rather than protect it. This chapter demonstrates that the structure of their industry, combined with the actions taken within the space of a decade, represents the manifestations of this underlying ethos and provided the agencies with the impetus to prosper beyond their wildest dreams, at a great cost to society.

3.2 The Oligopolistic Structure of the Ratings Industry

In 1.2 *The Industry: Who They Are* there were a number of references to the ratings industry as being a 'de facto' oligopoly, or perhaps even a 'partner-monopoly'[5]. Very little was said at that point in the thesis because the connotations attached to such structures require more analysis than would be appropriate within the 'primer' section. It is important to examine

[5] See 1.2. *The Industry: Who They Are* (n 9); (n 10); (n 11).

these connotations because if Suarez-Villa is correct in stating that 'the relations of power that oligopolies represent are largely ignored by the public today'[6], then providing a clear examination of the power structures within Oligopolies, and within the Rating Oligopoly in particular, will be very important indeed. In representing just one example of the power of an Oligopoly, Suarez-Villa qualifies this statement by confirming that the reason for this public ignorance is because the information that is needed to educate people to the potentially destructive power of these structures is lost in pro-corporate report after pro-corporate report that view corporate interests as 'beneficial to [almost] everyone'[7].

An *Oligopoly*, a Greek word meaning 'few sellers', describes an industry that has a small number of firms but who have incredible power as a result[8]. Perhaps the defining feature of an oligopoly is the interdependence between the members of the oligopoly, something which we shall see over and over again in our assessment of the ratings industry as an oligopoly. This notion of the members being interdependent makes analysing an oligopoly within generalised parameters difficult, mostly because each oligopoly will have different norms that influence the actions of its members. For example, the example given earlier[9] regarding OPEC, the Organisation of the Petroleum Exporting Countries, as being an almost monopolistic oligopoly because of its dynamics differs from the actions taken by Airlines, who are subject to different dynamics. OPEC members have their national position to consider and also have a product that is finite, whereas the Airlines operate for the benefit of their shareholders (for the most part) and offer a service to the public that has no defined end-date, which arguably results in a competitive nature not seen between the OPEC members who concentrate upon maximising the *collective* return from their position as opposed to *individual* return.

[6] Luis Suarez-Villa *Corporate Power, Oligopolies, and the Crisis of the State* (SUNY Press 2014) 10.
[7] ibid.
[8] McEachern (n 1) 233.
[9] (n 1).

However, whilst they are difficult to examine in general terms, there are aspects that (almost) all oligopolies share. The issue of competition is an inherent issue within any oligopoly, but is an issue that manifests itself in different forms. Every oligopoly contains inefficiencies because of competition[10], which often stems from the decrease in competitive pressures and usually leads to a reduction in quality (owing to the protected nature of each member's position), with the difference between each oligopoly perhaps being the conditions as discussed earlier; the competitive pressures at work in the rating oligopoly result in a lax approach that reduces quality whilst the openly-competitive nature of the Airline industry, albeit amongst a small number of providers (but not as concentrated as the ratings industry), results in a 'race-to-the-bottom' that incorporates price as well as quality (the price of ratings have not decreased as a result of the competitive dynamic within the rating oligopoly).

The dynamics within an oligopoly vary, but all are technically constrained by anti-competitive laws that a given jurisdiction has in place (anti-trust laws in the U.S. for example). So, to understand these dynamics within an oligopoly further the economic theory known as 'Game Theory'[11] can be particularly useful. The seminal work in this field, *Theory of Games and Economic Behaviour*, written by John Von Neumann and Oskar Morgenstern in 1947[12], started a theory that provides for an insight into the dynamics of oligopolistic interdependence (it was not until the 1970s that the field of Game Theory began to take shape)[13]. The theory views oligopolistic behaviour as a series of moves amongst rival firms within an oligopoly, with every move and countermove being concerned with the search for a possible equilibrium; as Stroux describes 'everything revolves around the search for a possible equilibrium or equilibria, i.e. a combination of the strategies that represent the best

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[10] James A Caporaso and David P Levine *Theories of Political Economy* (CUP 1992) 96.
[11] For a representative coverage of the literature on 'game theory' see James Friedman *Oligopoly Theory* (CUP Archive 1983) Ch. 9; Michael Waterson *Economic Theory of the Industry* (CUP Archive 1984) Ch. 3; Graham Romp *Game Theory: Introduction and Applications* (OUP 1997) Ch. 4.
[12] John Von Neumann and Oskar Morgenstern *Theory of Games and Economic Behaviour* (Princeton University Press 1947).
[13] Sigrid Stroux *US and EC Oligopoly Control* (Kluwer Law International 2004) 13.

strategy for every competitor, or player, who is presumed to make "rational" decisions in order to maximise profits'[14].

Whilst these elements are admittedly generalisations of the dynamics within an oligopoly, they are extraordinarily accurate when applied to the ratings industry. Even a cursory analysis of the actions of the agencies in the build-up to the Financial Crisis reveals the dynamics at play within the rating oligopoly. Speaking in general terms, Sabnavis notes that with regards to the rating oligopoly 'there are the classic elements of game theory here, where each agency does not know the stance taken by the other'[15]. In drawing conclusions from this understanding he suggests that the result of this is that the perceived penalty for a firm taking a 'strict' stance - whether this may mean economically, ethically, or something else - is that business will move towards the firm's competitor who has not taken such a strict stance; the obvious result being an incentive to increase the levels of liberality within the particular industry. Such liberal undertakings are rarely the precursor to sensible or ethically-based economic actions.

The dynamics within the rating oligopoly can be seen to be the most demonstrable 'cause' of the divergence between what is desired of the agencies and what they actually deliver. However, it is important to pause for a moment to consider the *strength* of the oligopoly, so that the analysis that follows is properly contextualised. The strength of an oligopoly can be measured, or at least understood, in a variety of ways. To begin with it is probably best to focus on the Big Three's, and in particular the Big Two's dominance of the industry. Tennant and Tracey note that across the world, between the 1970s and 2000s, only 68 new rating agencies were created, with only 4 being in existence before 1970. Additionally, the vast majority of these 'new' agencies tend to offer specialised services, which naturally prohibits

[14] ibid.
[15] Madan Sabnavis *Macroeconomics Demystified* (Tata McGraw-Hill Education 2008) 104.

them from ever posing a threat to the leaders in the field. In adding to some of the figures assessed in 1.2 *The Industry: Who They Are*, Tennant and Tracey state that the Big Three capture more than 90% of the value of all issues rated worldwide, and that Moody's and S&P have a combined global market share of 80% (with the Big Three having more than 95% of the market)[16]. While the figures regarding market capitalisation tend to differ ever so slightly between analyses, the sentiment is always the same; the Big Three, and the Big Two in particular, dominate the rating industry and therefore the industry is 'characterised by incomplete competition and an oligopolistic structure'[17]. There are a number of other indicators to provide support for this understanding of outright dominance of the industry by the Big Three[18].

The oligopolistic structure conveys a power that is rarely seen within other industry structures. Darbellay makes the point that whilst rating announcements clearly have an important impact upon the financial markets, it is the presence of a rating oligopoly that makes those announcements particularly powerful, 'especially if the three leading CRAs – even coincidentally – coordinate their rating practices'[19]. It is worth remembering that according to Game Theory, the likelihood is that the oligopolistic structure *dictates* that the rating practices of the leading agencies will be aligned, which is a particularly important issue to consider. So, with the potential power that can be wielded by the members of an oligopoly, it is worth examining how the agencies actually operate within the oligopoly. In doing so we will be able to assess the importance of the structure in relation to our understanding of there being a divergence between what is desired of the agencies and what is delivered.

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[16] David F Tennant and Marlon R Tracey *Sovereign Debt and Credit Rating Bias* (Palgrave Macmillan 2015) 53.
[17] ibid.
[18] See Ahmed Naciri *Credit Rating Governance: Global Credit Gatekeepers* (Routledge 2015) 55-60 for his analysis of indicators such as the amount of ratings issued, the amount of analysts employed and the revenue trends of each of the major rating agencies.
[19] Aline Darbellay *Regulating Credit Rating Agencies* (Edward Elgar 2013) 165.

Darbellay continues by stating that the Big Three have continuously been accused of abusing their market power and that the dominance of the rating market 'may have detrimental effects on the proper functioning of competitive forces in the rating industry'[20]. Darbellay is correct, but it is safe to go further and state that the oligopolistic structure *has* had a detrimental effect upon the proper functioning of competitive forces in the industry, rather than it *may*; whilst the oligopolistic structure is not the sole factor in this regard, as this chapter will ultimately demonstrate, it is an important factor. It has this detrimental effect because of certain elements that protect and advance the oligopoly, some of which are more obvious than others.

Perhaps the most prevalent argument regarding the protection of the oligopoly is that the oligopoly is a 'natural oligopoly'. Tennant and Tracey discuss studies that have concluded that the rating market is natural oligopoly, based upon the realisation that the nature of the market makes it extraordinarily difficult for new agencies to succeed. The scholars focus upon the large economies of scale that come with being the leading members of an oligopoly, which translate to the ability to hire more staff and be able to invest in better IT systems. It is correct, as Tennant and Tracey state, that 'new entrants have high start-up costs related to acquiring the requisite staffing, analytical tools and information technology systems, and few resources with which to meet these costs'[21]. The Big Three employ over 3000 credit analysts combined, which represents approximately 90% of the total number of analysts working for all of the NRSROs[22]. Therefore, it is clear to see why an influential issuer would not want to purchase the services of a smaller agency, simply due to the lower capacity the agency would have to deal with a complex issue. This leads onto the understanding that the concentration of resources allows for the Big Three to systematically dismantle any perceived threats through a coordinated campaign of acquisitions. The ability to acquire newer agencies is a particularly

[20] ibid.
[21] Tennant and Tracey (n 16) 54.
[22] ibid.

useful weapon for the established agencies; a weapon that is continually wielded[23] (hence the prevalence for start-ups to focus upon specialised sectors or local communities rather than a widespread coverage of their ratings, which would take them into the firing line of the Big Three).

Another issue that protects the oligopoly sees us revisit the notion of competition. Whilst in an industry such as the Airline industry, for example, competition may be expected to lead to a decrease in price for the consumer, the ratings industry operates within different parameters. The argument of those that claim the ratings industry is a natural oligopoly is that for the users of ratings, the investors, increased competition is simply not desired. The theoretical purpose of using ratings, from the perspective of the investor at least, is to *assist* with the deciphering of a issuing firm's financial position *whilst* keeping costs at a level which makes investing in a given firm's debt economically viable; if an investor had to survey a multitude of agencies' ratings then the use of ratings would become a hindrance rather than an aid, which would defeat the purpose. Andenas and Chiu, citing a paper by Lawrence J. White, explain that users' 'desire for consistency of ratings across investments products helps to sustain reliance on the few incumbents in the credit rating market. The multiplication of rating providers may decrease comparability and fuel race-to-the-bottom tendencies'[24]. We have seen in 1.4 *A Snapshot of the Regulatory Framework*[25], and will continue to see in Chapter 4 *Tried and Failed*, that the stated purposes of regulatory reforms have been to *increase* competition within the ratings market; with what we know now this is clearly a demonstration of the divergence between what is required and what is delivered – not considering the *actual* is a constant and important issue it seems.

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[23] See Herwig P Langohr and Patricia T Langohr *The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They Are Relevant* (John Wiley & Sons 2010) 386-410 for a representative analysis of the Big Three's acquisition strategies over the last decade (up unto 2010).

[24] Mads Andenas and Iris H Y Chiu *The Foundations and Future of Financial Regulation: Governance for Responsibility* (Routledge 2013) 197.

[25] 1.4 *A Snapshot of the Regulatory Framework* (n 108).

This position of the ‘user’, or more precisely the ‘investor’, and their requirements is a particularly important aspect to consider when it comes to assessing the justification for the oligopolistic structure within the rating industry. Schroeter, in sharing the views of White, argues that financial markets are ‘frequented by investors with a limited capacity to assimilate and process information… therefore always result[ing] in an investor-driven natural oligopoly of rating suppliers, making attempts to increase the number of relevant credit rating agencies futile’[26]. Whilst this assertion does not take into account the position of institutional investors, who do have the capability to assimilate and process information, the sentiment is indeed correct; the oligopoly is driven by the investors. However, there is an incredible situation that appears when we come to look at the qualities that these ‘incapable’ investors require. The main barrier to entry, that maintains the oligopoly, is widely accepted as being the issue of reputation, as Schroeter continues: ‘The prevailing opinion in the literature points to the high barriers of entry that new entrants to the credit rating business face, namely the challenge of having to develop and demonstrate a sufficient track record in order to acquire credibility with investors, which again is necessary to persuade issuers to buy their rating service’. Schroeter goes further by stating that it is precisely the oligopolistic structure, when understood in terms of the members each having over 100 years of experience, that maintains its existence; ‘new credit rating agencies therefore find themselves in a Catch-22 situation because they need a sufficient number of rating contracts in order to develop a reputation, which they fail to receive for lack of said reputation’[27].

However, while this understanding is true it is arguably obsolete, because as we shall see in much greater detail in 3.4 *Regulatory Reliance*, the concept of reputational capital was obliterated in 1973 with the incorporation of credit ratings into the burgeoning capital

[26] Ulrich G Schroeter ‘Credit Ratings and Credit Rating Agencies’ in Gerard Caprio *Handbook of Key Global Financial Markets, Institutions, and Infrastructure* (2013) 387.
[27] ibid 386.

markets; the forced usage of ratings produced by an NRSRO, a term which solidified the existence of the oligopoly, removed any reputational concerns the Big Three, and in particular the Big Two, may have had. In reality however, the NRSRO designation served to ratify the position of the Big Two, because the historical dominance of Moody's and S&P is seemingly the most important factor in the eyes of the investor (this is however an overly simplistic deduction, as we shall see throughout this section), although there are questions to be asked regarding the issue of perceived penalties for issuers for not choosing the Big Two[28]. It is worth noting that before the incorporation of the agencies' ratings the agencies were almost out of business[29], which can lead us to conclude that their reputation alone is not the reason for their successes.

The oligopolistic structure, therefore, is based upon this superficial notion of 'reputation', although in keeping with the analysis of the divergence between the *desired* and the *actual*, it is clear that any value users (and therefore issuers) place in the reputational capital of the agencies is not shared by the agencies; their abhorrent practices that contributed to the Financial Crisis are the clearest of indicators that losing any reputational capital is just not a concern for the agencies, despite their protests after the fact to the contrary. Perhaps a subsequent question that could be asked is why do investors continue to use the ratings of these agencies when the reputation that the investors value is simply not a concern for the agencies? One answer to this question lies in the notion of there not being a viable alternative, or 'substitute'[30].

To conclude this analysis of the oligopolistic structure as allowing for the divergence it will be helpful to assess this notion of there not being an alternative further. We have seen how

[28] See 2.3.1.1.2.1 *Rhinebridge (and Cheyne Finance) SIVs* (n 93) for the discussion regarding potential threats for selecting a competitor to the Big Two.
[29] Partnoy (n 2) 72.
[30] Tennant and Tracey (n 16) 53 'The elasticity of demand is, however, affected not only by the nature of the product/service, but also by the availability of substitutes'.

the oligopoly serves to protect itself by acquiring any perceived threats to its existence, whilst we have also seen how the dynamics of the requirements of the end-users of the ratings dictate that the oligopoly exists. Yet, is it really the case that any attempts to increase the number of relevant agencies would be futile? Is the oligopoly irremovable? In the analysis that follows we shall see that whilst there are a number of advanced alternatives that are very unlikely to affect the position of the oligopoly, there are some that could transform the *nature* of the oligopoly, if the appetite to do so existed (which is another issue that needs to be covered). Perhaps the underlying question that needs to be considered here is whether an oligopoly as a structure fundamentally dictates the conduct of its members, or whether the nature of the oligopoly's members dictates the conduct of the oligopoly?

3.2.1 Proposed Alternatives to the Rating Oligopoly

The first alternatives that are worth examining, to show the extremes that exist if nothing else, are from Frank Partnoy and Emilios Avgouleas. Partnoy suggests that the rating agencies' informational value is so low that replacing their credit ratings as signifiers of market performance with market-based measures such as 'credit spreads' would be much more appropriate and efficient[31] (credit spreads are the difference in yield between any type of bond and a US treasury of the same maturity [that are considered to carry no risk of default]). Partnoy counters the arguments against the use of market-based measures by stating that though the measures may be volatile (because of the attachment to the volatility of the market), it is infinitely better if the regulators could make transparent choices about this volatility rather than leaving it to the agencies that do not consider systemic consequences.

[31] Partnoy (n 3). Partnoy also suggests that credit default swaps would be a better method than using ratings.

The volatility in rating downgrades, which may be just as *subjective* as the rating process seen before the crisis, is obviously a counterbalance to the criticisms against the use of market-based measures. There is however a different criticism which is harder to argue against, as we shall see shortly.

Avgouleas also argues for the removal of the rating agencies. However, his arguments with regards to the rating agencies are part of systemic transformation, which separates it from Partnoy's proposals. He argues for a recalibration of accepted governance models and centres the new framework on a redeveloped OECD (Organisation for Economic Co-operation and Development) that incorporates research expertise from the Bank of International Settlements (BIS)[32]. The issue however with this 'big-bang' approach is that it requires so much political appetite, the likes of which have arguably never been seen, that considering it can only be an academic exercise. Although Avgouleas and Partnoy should be praised for offering alternatives, because as Avgouleas rightly states such exercises being academic should not stop people from advancing them[33], examining the potential for application is also an important exercise. In doing this, it quickly becomes clear that there is little appetite for the complete removal of the agencies (for a variety of reasons that will be discussed throughout the section).

In a similar vein to calling for an alternative that effectively seeks to eliminate the rating agencies, there are a growing number of proposals that argue for the public provision of credit ratings. The argument is based upon the notion that the provision of credit ratings is a 'public good' and as such 'the public should be responsible for financing the production of this information'[34]. There are clear benefits attached to this approach as some scholars have

[32] Avgouleas (n 3) 450. For the proposal itself see 394-447.
[33] ibid 431.
[34] Viktar Fedaseyeu 'Economics of Information' in Rhona C Free *21st Century Economics: A Reference Handbook* (SAGE Publications 2010) 736.

claimed: ‘a public rating agency would not just be financially independent from issuers but it would be open to a level of public scrutiny that even heavily regulated private companies are not submitted to’[35]. However, there are a multitude of issues with the public agency approach.

If the state provides the funding for this agency, a new conflict of interest appears, as Listokin and Taibleson note: ‘if money comes from the public fisc, then all taxpayers must pay for a product that directly benefits only a narrow class of investors’[36]. If the answer is to force investors to pay the costs, then deciding which class of investors must meet this obligation is just as problematic[37]. Also, the fact that private institutions usually pump considerably more resources into research than the state does is another element that needs to be considered; would the research conducted by the public agency be extensive enough to meet the demands that are placed upon the current agencies? Also, if the state were to set up a rating agency, it would theoretically lose the authority it requires based on the notion that rating agencies have their authority based on their independence (it would also do no favours for the US-centric allegations aimed at the current industry structure[38]).

Therefore it is not reasonable to suggest that the state would sanction enough resources to meet the requirements that are on the current agencies, as it is understood that the private sector devotes considerably more resources to research in almost every sector[39]. In addition to this, if issuers now court the ratings of two agencies (at least) and investors tend to take into account two ratings, then does that mean the state will have to create two separate agencies?

[35] Akos Rona-Tas and Stefanie Hiss ‘The Role of Ratings in the Subprime Mortgage Crisis: The Art of Corporate and the Science of Consumer Rating’ in Michael Lounsbury and Paul M Hirsch *Markets on Trial: The Economic Sociology of the U.S. Financial Crisis, Part 1* (Emerald Group Publishing 2010) 149.
[36] Yair Listokin and Benjamin Taibleson ‘If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation’ [2010] 27 Yale Journal on Regulation 96 102.
[37] ibid.
[38] Kenneth Dyson *States, Debt, and Power: ‘Saints’ and ‘Sinners’ in European History and Integration* (OUP 2014) 390.
[39] Fedaseyeu (n 34).

This would double the cost and make no impact on the differential independence. Lastly, the legal problems that would emerge from claims by investors that they lost money after using information that was directly produced by the state would make the whole endeavour counter-productive. Overall, the proposal is preferable within a perfect environment, but within the real environment it is simply not practicable.

3.2.2 Supplementation

There are some proposals however that do not seek to remove the agencies, but challenge their dominance. The preface to these approaches is the 'public utility' model, whereby the state would set up and manage an agency that would produce ratings not to be used by investors for usual purposes, but used by investors to check the validity of the rating agencies[40]. The problem with this approach of course is governmental intervention in no way guarantees the accuracy of the rating. But, the idea is useful. The idea is useful only if a rating agency that could demonstrate a high enough level of independence, and also develop a reputation for its accuracy, would take on the role of 'bench-marker'. At first glance there is an issue here in that who would take on such a role when there was no financial reward to be gained from it?

This is where, potentially, non-profit offerings start to make more sense. There are two non-profit credit rating agency proposals that are worth considering. Firstly there is the 'Credit Rating Initiative' that was developed by Jin-Chuan Duan as part of the National University of

[40] Raquel G Alcubilla and Javier R del Pozo *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (OUP 2012) 249.

Singapore's Risk Management Institute[41]. The project aims to develop an organic 'selective-Wikipedia-style' database of credit rating assessments on hundreds of thousands of firms, covering 'macroeconomic, financial and default related information'[42]. By publishing daily PDs (Probability of Default), the Initiative is aiming to provide a purely public good. The project's initial cost was $5 million, with the proposed model going forward being to apply for grants to meet the operational costs.

The other version is the International Non-Profit Credit Rating Agency (INCRA), developed by the Bertelsmann Foundation. INCRA aims to provide sovereign ratings that incorporate not just economic and short-term socio-political factors, but also incorporate long-term socio-political factors[43]. The agency proposes to develop transparent and accountable governance structures within the agency that it hopes will stimulate funding. However, the issue of funding is again an issue, with the agency predicting that $400 million would be required to begin and maintain operations. The Foundation's target for funding is the G20, which it argues should fund INCRA to reduce costs that will occur later through CRA failures.

The two endeavours unfortunately share a common problem; it is proving difficult to generate funding because of what they are offering. They are both offering an addendum to the current credit rating system, in that it gives investors the opportunity to compare against an established rating agencies' output. However, there is a massive issue here; this facility already exists, arguably, with the smaller NRSROs who operate on an investor-pays basis (mostly just Egan-Jones in this respect, although smaller agencies are often used for this purpose irrespective of their remuneration model). Their ratings are considered independent from any issuer influence, and are commonly used by the larger investors to gain perspective

[41] Jin-Chuan Duan and Elisabeth Van Laere 'A *public good* approach to credit rating – from concept to reality' [2012] 36 Journal of Banking & Finance 3240.
[42] ibid 3243.
[43] Bertelsmann Stiftung *Blueprint for INCRA – An International Non-profit Credit Rating Industry: Executive Summary* (2012).

and check conformity on the Big Three's ratings on the more obvious credit ratings. The level of independence, and therefore perceived accuracy, is arguably less than the smaller NRSROs should the two endeavours obtain the public funding they are hoping for. I have argued elsewhere that the two entities should perhaps combine so as to cover all aspects of the provision of credit ratings, and that they should also seek funding from private philanthropic sources, in order to increase their all-important perceived independence. There is also a role that seems perfectly suited for the agencies, where they to combine, within current SEC regulations, which resembles closely the public utility model discussed earlier[44].

The conclusion that must be drawn from this analysis of alternatives to the current system is that they are not particularly viable in their current forms. More research needs to be conducted into how these alternatives may be amended to fit the current system, rather than overhaul it. The reason for this is not because overhauling the system as we know it is incorrect, but it is particularly impracticable given the dynamics that exist currently; one can imagine that The Big Three would spend everything they had lobbying against their removal. The dynamics of the rating oligopoly are perhaps unique. We have seen that the structure is determined by the requirements of the end-users, the investors, which fundamentally prescribe the actions of every participant within the ratings market. It has been noted that issuers, who actually pay for the ratings, are only concerned with the agency that enjoys the most market reliance[45]; if this is the case then reducing the influence of the Big Two will be particularly difficult, but not impossible. While large impactful reforms may be interesting to consider, it is arguable that they can never be realised. What can be realised however are incremental reform proposals that incorporate the *actual* dynamics of the industry, rather than what is *desired*.

[44] Daniel Cash 'The International Non-Profit Credit Rating Agency: The Viability of a Response' [2016] 37 The Company Lawyer 6.
[45] Darbellay (n 19) 169.

Now that we have established how the oligopolistic structure of the rating industry allows for its transgressions, we can now move on to examine the other aspects which coalesce to result in the extraordinary confidence that the agencies have whilst they are transgressing. The oligopolistic structure protects the agencies because its 'naturalness' means that new competitive pressures *are not forthcoming*, which in itself is a major reason for the actions of the agencies. The question of whether it is the oligopolistic structure that dictates the actions of its components, or whether it is the components' sentiments that dictate the nature of the oligopoly is an interesting one, and will be answered in the conclusion to this chapter. What is clear now though is that the nature of the rating oligopoly is at once both protective and advancing, and certainly needs to be considered when one advances a reform proposal.

3.3 The Issuer-Pays Remuneration Model

The issuer-pays remuneration model was first adopted in 1969, and operates on a simple basis: credit ratings are initiated by issuers, rather than investors, who approach the agency and order a creditworthiness assessment; the payment for this service can range from $1,500 to $2,500,000, depending upon the size and issue of the given security[46]. Schroeter suggests that agencies operating under this model determined 99% of the total outstanding credit ratings in the United States[47], which demonstrates the importance of assessing this model and revealing its advantages and disadvantages. The vast majority of the literature, including this thesis, focuses upon the negative aspects of this model. However, there are arguments *for* the model that have to be included before we continue. Probably the most obvious and rational one is that without it the agencies simply could not meet the demand that they are faced with.

[46] Schroeter (n 26) 383.
[47] ibid.

Alcubilla and del Pozo note that 'new markets required more specialisation, more qualified and higher paid analysts, lawyers and compliance officers, the opening of offices in regional areas, and so on. And the increased costs associated with the production of ratings of quality could not be funded just by subscribers'[48]; the reason why this cost cannot be met by subscribers is because technological advancement created the ability for subscribers to share the rating information with non-subscribers (this will be discussed more in 3.3.1.2 *The Impact of Technological Advancement*).

In addition to this practical 'advantage', there is a theoretical advantage created by the issuer-pays model, in that the agency must liaise with the issuer (their client) and this 'provides the rating analysts with a better understanding of the issuer's financial situation and business prospects'[49]; this affirms what was discussed earlier with regards to 'Signalling Theory'[50]. In what is arguably the only other argument *for* the model, rating agencies themselves vehemently argue that the perceived ills of the issuer-pays model would also be witnessed in the subscriber-pays model. Their argument is based upon the notion that the paying party naturally wants the situation to be geared towards their advancement over the opposing party; the suggestion being that 'investors would prefer lower ratings (since they will then receive higher yields), as would the short sellers of any other security of the issuing company'[51]. These points are representative of the arguments *for* the adoption and continuation of the issuer-pays model, but, as we shall see throughout this section, there are so many other factors that these simplistic understandings do not consider.

So, to thoroughly assess the concept of issuer-pays and how it relates to our analysis of the divergence, the section will split into two clearly defined sub-sections. Firstly, we shall assess

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[48] Alcubilla and del Pozo (n 40) 248.
[49] Schroeter (n 26) 383.
[50] See 2.2.1 *The Desired Situation for Issuers*.
[51] Matthew Richardson and Lawrence J White 'The Rating Agencies: Is Regulation the Answer?' in Viral V Acharya and Matthew Richardson *Restoring Financial Stability: How to Repair a Failed System* (John Wiley & Sons 2009) 107.

the commonly accepted hypotheses for the reasons why the issuer-pays model was adopted in the first place; doing so will add to our assessment of why the agencies transgress in the way that they do and also, interestingly, reveal how common misconceptions contribute to the divergence. After this we shall then assess some of the negative effects of the issuer-pays model, in opposition to the claims advanced by the agencies, to determine how it contributed to the creation of the divergence, and also how it is a vitally important tool to the agencies in widening the divergence.

3.3.1 Hypotheses for the Adoption of the Issuer-Pays Model

A definitive explanation for the adoption of the issuer-pays model would reveal the mentality of the industry at that time, which would go a long way to confirming the existence of an underlying approach taken by the industry (as will be advanced in the last section to this chapter). However, 'the reasons for this change have never been established definitively'[52]. So, in light of this fact, what follows is an assessment of the two commonly accepted reasons for this change in policy: as a response to the collapse of Penn Central; and as a response to technological advances witnessed in the late 1960s

3.3.1.1 The Collapse of Penn Central Hypothesis

That the rating agencies altered their remuneration models as a reaction to the changing market dynamics after the collapse of Penn Central in 1970 is by far and away the most

[52] Lawrence J White 'Financial Regulation and the Current Crisis: A Guide for Antitrust' in American Bar Association *Competition as Public Policy* (American Bar Association 2010) 90 (footnote 90).

common hypothesis. The hypothesis intimates that the increased nervousness felt by investors after the collapse altered the market dynamics in that investors no longer trusted in 'household names', with the result being that they required some third-party verification to calm their nerves when investing[53]. Yet, this version of events paints a picture of a passive industry being given the opportunity to play a central role just by pure chance; nothing that has been discussed so far in this thesis should lead one to accept that the ratings industry has developed by chance alone. The important question to ask will be 'does this hypothesis hold up under scrutiny?'

The proponents of this hypothesis are wide and varied: Partnoy states that 'when Penn Central defaulted in 1970 on $82 million of commercial paper, investors began demanding more sophisticated levels of research'[54]. Geisst tells us that a 'potential revenue source presented itself following the default of the Penn Central Railroad in 1970… to assure nervous investors, issuers of commercial paper sought out and paid for objective ratings of their commercial paper issues'[55]. These statements are representative of a number of sources that subscribe to the same view[56].

The clarity with which these proponents make the statement is such that it suggests that no other alternative explanation exists. For example, Hudson, Colley and Largan are emphatic in their proclamation that 'at that time, investors relied on name recognition as the principal criterion for issuer selection'[57]. If this was the case that would mean that the *industry* was

[53] Larry Allen *The Encyclopedia of Money* (ABC-CLIO 2009) 94.
[54] Partnoy (n 2) 72.
[55] Charles R Geisst *Encyclopedia of American Business History* (Facts on File 2006) 112.
[56] Just some of the many works that are representative of this view include Enrica Detragiache 'Rational Liquidity Crises in the Sovereign Debt Market: In Search of Theory' [1996] 43 International Monetary Fund: Staff Papers 3 565; Daniel Immergluck *Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America's Mortgage Market* (Cornell University Press 2011) 111; Benjamin Taupin 'Perpetuating the Regulatory Order in the Credit Rating Industry' in Isabelle Hault and Chrystelle Richard *Finance: The Discreet Regulator – How Financial Activities Shape and Transform the World* (Palgrave Macmillan 2012) 86; Allen (n 53) 94.
[57] Robert Hudson, Alan Colley, and Mark Largan *The Capital Markets and Financial Management in Banking* (Routledge 2013) 175.

almost non-existent, or at least extremely ineffectual, which is an understanding that tallies with previous statements made by other proponents[58] regarding the health of the *rating* industry prior to 1970. However, there is a reason why the words 'industry' and 'rating' where emphasised in the preceding sentence; there is an incredibly poor oversight made by many when they differentiate between the pathways of the reporting agencies, like Dun & Bradstreet, and the rating agencies like Moody's and Standard & Poor's. The credit reporting industry was not in poor health like the rating agencies, and the ownership structures between the two industries reveal that to differentiate between them during this crucial period in the 1960s and 1970s is an important oversight. Although it will form the central component of the last section of this chapter, it is worth noting here that up until 2000 Moody's was owned by Dun & Bradstreet, having purchased the company in 1962 upon John Moody's death[59]; with Moody's being the first rating agency to initiate the issuer-pays model on an extensive scale in 1970[60] it is clearly an important oversight to overlook the position of the parent company at that time.

So, in what represents a wildly different take on the conditions in the economy before the collapse of Penn Central, the SEC in its Staff Report on the collapse of Penn Central confirmed that the 'National Credit Office' (NCO) was 'the only national rating service of commercial paper'[61], which when combined with the importance of the commercial paper market to the American economy in the late 1960s (and early 1970s) demonstrates the importance and centrality of Dun & Bradstreet's National Credit Office[62]. The NCO was a

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58 Partnoy (n 2).
59 Geisst (n 55) 111.
60 Moody's began using the issuer-pays model in 1970 after Standard & Poor's had begun using the model in its Municipal Bond rating service in 1969, see Naciri (n 18) 16.
61 Securities and Exchange Commission *The Financial Collapse of the Penn Central Company: Staff Report of the SEC to the Special Subcommittee on Investigations* (GPO 1972) 10.
62 Markham notes that 'Corporations in America were borrowing large amounts of money in May of 1970 through the commercial paper market. Outstanding commercial paper rose from $17.5 billion to $38 billion between April of 1968 and April of 1970', see Jerry W Markham *A Financial History of the United States: From Enron-Era Scandals to the Great Recession* (Routledge 2015) 5.

part of Dun & Bradstreet in the same manner that Moody's Investment Services was, and was acquired through a merger with Arthur D. Whiteside in 1931[63]. The SEC continued by noting that 'customers relied heavily on the NCO prime rating as an independent opinion of the creditworthiness of commercial paper issuers'[64], which clearly flies in the face of the claims of those mentioned earlier with regards to investors simply 'trusting' in issuers' abilities to pay back their debts (which is arguably a ludicrous suggestion given the 170 years of experience exhibited by the rating/reporting industry).

In presenting the NCO we simultaneously debunk two common misconceptions: firstly that investors simply relied upon the reputation of issuers when determining creditworthiness; and secondly that 'the late 1940s, 1950s, and 1960s were happier to both issuers and holders of securities, but for the rating agencies the times were perhaps too good: no one seemed to default'[65]. The first misconception is debunked by the SEC's Staff Report. The second misconception can be set straight by understanding that the 'prime rating' awarded by the NCO was the equivalent of today's AAA rating from the rating agencies. Fight confirms that the NCO had more than 600 commercial paper ratings outstanding at the time of Penn Central's collapse, and that all of them were 'prime', which not only should strike a chord with respect to our understanding of the events of 2007/08, but also reveals that the availability of 'prime' ratings, that investors 'relied' upon, ultimately meant that the malaise experienced by rating agencies was solely due to the liberality of their reporting partners, as Fight affirms: 'Who would want to run the risk of a lower credit rating when the National Credit Office was certain to award a Prime rating?'[66].

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[63] Whiteside would bring the National Credit Office with him when he joined Dun & Bradstreet, two years before his company would eventually merge with D&B, see 'Your Credit Good? Dun & Bradstreet Knows' [1947] Kiplinger's Magazine September edition 28.
[64] Securities and Exchange Commission (n 61).
[65] Abdelal (n 2) 167.
[66] Andrew Fight *Understanding International Bank Risk* (John Wiley & Sons 2004) 48.

So, the hypothesis that rating agencies began charging issuers for ratings because the collapse of Penn Central made investors nervous about investing can be dismissed, because as we have seen it was not the case that some implicit trust was shattered by the shock collapse of a major national company. However, that is not the end of the story. In understanding further the collapse of Penn Central, and the involvement of the NCO in that collapse, we shall see two things: firstly that rather than it being the case that some implicit trust was broken, it was actually the case that investors were betrayed by the NCO; and secondly that the comparisons with the recent financial crisis are very similar indeed. Again, the words of Machiavelli are appropriate here, as is the commonly misattributed line from Mark Twain: 'History never repeats itself but it rhymes'[67].

To understand the collapse of Penn Central we must first understand the commercial paper market and what it represented in the late 1960s/early 1970s. Commercial paper usually takes the form of 'short-term unsecured promissory notes', which at the time provided a very attractive alternative to bank financing for short-term borrowing owing to it being a particularly inexpensive mode of financing, which was easy to use and viewed by investors 'as almost entirely without risk'[68]. As we now know this belief was not due to an implicit belief in the creditworthiness of commercial paper issues, but the widespread coverage of the NCO's prime ratings.

It is because of this widespread belief in the safety of commercial paper that the collapse of Penn Central caused such a shock to the economy. Penn Central was a subsidiary of a larger holding company, The Penn Central Transportation Company, which was the largest

[67] The usage here was initially based upon Richard Sylla's usage of the quote from Mark Twain in Richard Sylla 'An Historical Primer on the Business of Credit Ratings' in Richard M Levich, Giovanni Majnoni and Carmen Reinhart *Ratings, Rating Agencies, and the Global Financial System* (Kluwer 2002) 34. However, further research confirms that the quote has been mistakenly attributed to Twain, and in fact stems from John R Colombo *Neo Poems* (Sono Nis Press 1970) in which a poem contains the line '"History never repeats itself but it rhymes", said Mark Twain'.

[68] J W Hicks 'Commercial Paper: An Exempted Security Under Section 3 (a)(3) of the Securities Act of 1933' [1976] 24 UCLA Law Review 227.

nonfinancial company in the United States; at one point the Company held over $200 million in commercial paper[69] (the US Government would go onto transform the remnants of Penn Central into Amtrak in 1971). Yet, despite its size and dominance of the market place, the Company was heavily criticised for a number of things including its structure, its operations and widespread mismanagement[70], which adds further weight to the claim made here that rather than relying on the reputation of these large companies (which was not exactly pristine), the investors relied upon a third party to verify the creditworthiness of these large companies.

The company would go on to file for bankruptcy on June the 21st 1970, after running into financial difficulties. The company had in essence over-leveraged itself: it struggled to integrate an extensive transportation network that stretched from St. Louis to Boston to Canada; it was being constrained by governmental regulation (owing to their providing a 'public good'); it was running money-losing passenger trains; and was suffering from endemic mismanagement[71]. At the time of bankruptcy it defaulted on $80 million (or $82 million dependent upon the source[72]) worth of commercial paper, making it the largest bankruptcy in U.S. history at that point.

So, in the investigations that followed this enormous collapse, a number of telling aspects were revealed that implicated the NCO, but also revealed a familiar pattern within the economy that is particularly disheartening. Firstly, the SEC noted that as opposed to the usual practice where commercial paper is concerned, Penn Central was using it as if it were long-term financing, which alludes to Penn Central over-leveraging itself (the report also reveals

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[69] Markham (n 62) 5.

[70] For a sample of the general discussion and criticism of Penn Central see Joseph R Daughen and Peter Binzen *The Wreck of the Penn Central* (Beard Books 1999); Michael Bezilla and Jack Rudnicki *Rails to Penn State: The Story of the Bellefonte Central* (Stackpole Books 2007); Clifton Wilcox *Groupthink: An Impediment to Success* (Xlibris Corporation 2010) 43-5.

[71] Bezilla and Rudnicki (n 70) 247.

[72] Markham (n 62) 5 states $80 million, whilst Partnoy (n 2) 72 states $82 million.

multiple financial arrangements like $100 million debentures that were an attempt to keep afloat). In addition to the multiple instances of insider trading amongst executives, the firm was also operating against its investors for the benefit of investment banks, Goldman Sachs in particular, by way of providing Goldman Sachs with advanced warning of financial troubles in the firm *whilst* concealing all negative information to the investing public; during this whole period, the NCO never once removed its prime rating. Goldman Sachs would act upon this information and would go on to purposefully but covertly reduce its holding in the company whilst maintaining the appearance of holding a significant stake; the result being that investors were fraudulently soothed by the presence of Goldman Sachs – at the time of bankruptcy Goldman Sachs held none of the commercial paper issued by the railroad company[73].

Although legal action was brought against Goldman Sachs (and the NCO as a part of that action), the individual nature of that particular case resulted in the court finding that the plaintiff was not in a position to have relied upon the NCO's prime ratings (the plaintiff was not a subscriber to the NCO but had received the information regarding the prime rating, allegedly, from a Goldman Sachs employee)[74]. So, even though the reporting agency was complicit in the largest bankruptcy in US history (which we know with hindsight would not be the last time), there were very few consequences for their actions.

Before we conclude this section it will be worthwhile understanding the NCO a little more. The NCO, which had been rating commercial paper since 1920 and was in effect the only national rater in that market, was never registered with the SEC as an investment advisor; it was only after the collapse of Penn Central that Dun & Bradstreet transferred the NCO to Moody's Investors Service which at that point was a registered investment advisor. The SEC

[73] Securities and Exchange Commission (n 61) 10.
[74] *Mallinckrodt Chemical Works v. Goldman, Sachs & Co*., 420 F. Supp. 231 (S.D.N.Y. 1976).

stated in their report that the NCO grew concomitantly with the commercial paper market in the late 1960s, and that 'most of the data contained in the NCO releases [was] a mere reprint of Penn Central press releases or excerpts from annual reports'; the similarities to the modern rating agencies are incredible and suggest that differentiating between the path taken by the reporting agencies and rating agencies is a potentially serious oversight. Furthermore, dealers were utilising NCO ratings as a marketing tool because many customers 'were required by statute or resolutions of their boards of directors or trustees, to purchase only that commercial paper which was rated prime by NCO'[75]. It also alludes to an understanding that the structure of the market, whether it is monopolistic or oligopolistic, is irrelevant when there is an underlying will to capitalise upon one's position irrespective of the damage that may be caused.

This incredible likeness and evidence of complicity perhaps reveals one important aspect that we must not ignore. The need to be thorough and critical when passing comment is of the utmost importance. Irrespective of intention, the story of the rating agencies simply being mandated by the investing public to provide ratings, based upon the lack of a third-party beforehand, is not only erroneous but misleading and has the potential to warp any analyses that are based upon that notion; that version of events is the intellectual foundation that is used by the industry and its proponents to justify its position as one of necessity. We shall now see in the remainder of this chapter that rather than the industry fulfilling a societal need, they purposefully create the environment around them through opportunistic and on occasion callous behaviour; this is the *actual* that must be considered.

[75] Securities and Exchange Commission (n 61) 294.

3.3.1.2 The Impact of Technological Advancement

So, if it was not the case that the rating agencies adopted the issuer-pays model because of an overwhelming desire from investors to have a third-party verify a firm's creditworthiness, what were the reasons for its adoption? The answer to that question lies in the understanding that technological advancement in the late 1960s essentially forced the agencies into a corner, forcing them to act. Whilst it is the case that the fall of the Bretton Woods monetary system facilitated the explosion of the capital markets[76], which in turn empowered the agencies given the centrality of their service to the requirements of the burgeoning capital markets[77], the fall of the system represented the *opportunity* to take advantage of their position, not to implement the issuer-pays model, because quite simply the agencies had already incorporated the model (to differing levels initially) a few years before the collapse of Bretton Woods.

Simply put, technological advancements were a real threat to the agencies because the agencies' ability to charge investors (or any consumer) for the service of published credit ratings was obliterated because of the 'free rider' problem. A simplified explanation of the 'free-riding' concept would be when an entity cannot capture the benefits of producing a product because that product can be duplicated or shared easily, which results in the undersupply of that product (if those conditions that prompted free-riding persist). Though this concept is part of a larger theoretical discipline known as Public Choice theory (as part of

[76] For a representative analysis of the Bretton Woods monetary system see Michael D Bordo and Barry Eichengreen *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform* (University of Chicago Press 2007); Benn Steil *The Battle of Bretton Woods: John Maynard Keynes, Harry Dexter White, and the Making of a New World Order* (Princeton University Press 2013); Eric Helleiner *Forgotten Foundations of Bretton Woods: International Development and the Making of the Postwar Order* (Cornell University Press 2014). For a specific discussion of the expansion of the capital markets as a result of the collapse of Bretton Woods see Alcubilla and del Pozo (n 40) 6.
[77] Cormac Butler *Accounting for Financial Instruments* (John Wiley & Sons 2009) 58.

the study of Regulation), which in itself can be an important theoretical framework with which one can examine the ratings industry[78], for now this simplified description will suffice. It will suffice because the impact of this concept upon the agencies in the 1960s and 1970s is straightforward, as just one analysis that is representative of the literature states:

> 'Starting at this time, the major rating agencies began to charge issuers for ratings assessments. One reason was the diminishing viability of investor subscriptions as a source of financing ratings. Technological changes in the dissemination of information, including the spreading use of photocopying, had made it increasingly difficult to restrict the beneficial use of ratings assessments only to paying subscribers. Since ratings information quickly became available to most market participants, the free-rider problem intensified and the value of subscribing to a rating service was diminished'[79].

This succinct understanding is universally accepted across the literature[80]. The threat itself came from the new product released by the Xerox Corporation, the Xerox 914, which was advertised on Television in 1959 and subsequently became a vital part of Xerox's revenues

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[78] The Public Choice field is extensive, and concerns itself with a number of issues regarding the use of economic tools to study political issues. For our analysis this relates to the claims that rating agencies are providing a 'public good' by way of the method in which credit ratings are provided (i.e. they are free to all [nonexcludable], and the consumption of the rating does not affect the consumption by another [nonrival]). As usual however, this narrative does not detail the *actual* version of events, as Langohr and Langohr explain when they reveal that the most relevant and user-friendly information is secluded behind pay walls, see Langohr and Langohr (n 23) 173. For a sample of the literature that position the agencies as a provider of a public good see Jeffrey Manns 'Rating Risk after the Subprime Mortgages Crisis: A User Fee Approach for Rating Agency Accountability' [2007-08] 87 North Carolina Law Review 1060; Mohammed Hemraj *Credit Rating Agencies: Self-Regulation, Statutory Regulation and Case Law Regulation in the United States and European Union* (Springer 2015) 1. For just a very small sample of the seminal works in the Public Choice field see Arthur C Pigou *The Economics of Welfare* (Macmillan and Company 1920); Paul A Samuelson 'The Pure Theory of Public Expenditure' [1954] 36 The Review of Economics and Statistics 4; James M Buchanan and Robert D Tollison *The Theory of Public Choice* (University of Michigan Press 1962); John G Head 'Public Goods and Public Policy' [1962] 17 Public Finance 3; Mancur Olson *The Logic of Collective Action: Public Goods and the Theory of Groups* (Schocken Books 1968); Ronald H Coase 'The Lighthouse in Economics' [1974] 17 Journal of Law and Economics 2.

[79] Andrew Crockett *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?* (Centre for Economic Policy Research 2003) 45.

[80] Robert M Hardaway *Great American Housing Bubble: The Road to Collapse* (ABC-CLIO 2011) 146; Gianluca Mattarocci *The Independence of Credit Rating Agencies: How Business Models and Regulators Interact* (Academic Press 2014) 72; White (n 52).

(thus highlighting its popularity)[81]. The popularity of the model therefore dictated that the agencies simply could not garner any financial recompense from subscribers, which was in addition to the paucity of subscribers anyway because of the preference for believing in the 'prime' assessments of the NCO. What was becoming apparent to the ratings industry is that without an event that would change the dynamics of the economy they would most likely go out of business.

That this threat was clearly understood by the agencies is not surprising, but it is at this point that we must apply what we know about the agencies and how they operate to an analysis of that particular era. In the 1960s the agencies were being dominated by the NCO, primarily because the NCO was the only national assessor within the Commercial Paper market, which was the driver for economic activity. Furthermore, they were faced with a real threat of extinction because whatever revenue they could garner from subscribers would likely be lost because of free-riders utilising the technology that was available in the 1960s. So, the official story goes from this chain of events to the issuer-pays model being adopted in 1970; it is clear to see that there is a part missing. The fall of the Bretton Woods monetary system in the late 1960s had the effect of escalating the capital markets which in turn created the need for third-party verification (even after the failings of the NCO). However, this narrative means that the potential to change the remuneration model, based upon the issuer needing to signify to the now global markets their creditworthiness (a new market which had different requirements than the Commercial Paper market), happened *just by chance*. It is this understanding of events that leads to a possible line of future research; what was the level of direct involvement by the agencies in bringing about the fall of Bretton Woods? It is documented that large and influential companies lobbied heavily to promote a freer market

[81] Eva H Wirten *No Trespassing: Authorship, Intellectual Property Rights, and the Boundaries of Globalisation* (The University of Toronto Press 2004) 61.

during the 1960s[82], which cumulated in the demise of Bretton Woods. What is not known however is the differentiation within this concerted lobbying campaign, which in an era of limited publicly-available information would be particularly difficult to source, admittedly. What can be said is that given our analysis of the rating industry so far, it is just too coincidental that the capital markets, which naturally rely upon the presence of a third-party to verify creditworthiness, would open up just at the time the industry was facing extinction; it may be a stretch to suggest that the rating agencies played a significant role in destroying an international monetary system, but to rule out any involvement in light of what we know would surely be imprudent.

3.3.2 The Effects of the Issuer-Pays Remuneration Model

Schroeter's analysis of the advantages and disadvantages that are inherent within the issuer-pays model is a good place to start this section. In describing the advantages, Schroeter advances the notion that the increased exposure to issuers, as opposed to under the subscriber-pays model, results in a more open relationship that has the theoretical potential to increase the amount of information within the system as a whole i.e. ratings analysts will have more information which should therefore result in a more accurate rating; this was discussed earlier with regards to the concept of Signalling Theory[83]. In describing the disadvantages, Schroeter states that the primary disadvantage is the obvious conflict that arises out of the arrangement: 'since it is in every issuer's economic interest to receive as high a rating as possible, there is an incentive for the credit rating agency not to displease the

[82] Benjamin C Waterhouse *Lobbying America: The Politics of Business from Nixon to NAFTA* (Princeton University Press 2013) 34.
[83] (n 49).

paying issuers, lest he may take his future rating business elsewhere'[84]. Yet, as Schroeter understands, the situation regarding competitive pressures differs between the corporate bond and structured product markets (investors, and therefore issuers, usually only require one rating for a structured product, which increases the competitive pressure within the oligopoly, as opposed to the corporate bond market where two ratings are usually mandated). Not giving a favourable structured product rating will result in lost business, which may result in further lost business because that issuer, who may well also have corporate bond ratings outstanding, may choose to use the third member of the oligopoly, Fitch Ratings, to discipline the offending agency[85] (this does not take into account the revenues that may be withdrawn from the ancillary service business as well, but that discussion is best saved for Chapter 5).

So, the issuer-pays model transformed the ethos of the rating agencies so that their fortunes are inextricably linked to the will of the issuers. This tying of the agencies' ethos to the will of the issuer is demonstrated when we consider that an investor needs to have the rating constantly reviewed so that the information is accurate and up-to-date. However, because the agency is only concerned with the will of its client, who as an issuer will only be concerned with the *initial* rating (so that the debt can be traded), the lack of incentive created by the issuer-pays model to review ratings has the potential of being an extremely important consequence of this particular conflict of interest. This also relates to the nature of the oligopoly when, as Dombalagian states, 'the highly concentrated nature of the credit-rating industry may reduce the incentive for established credit-rating agencies to compete on the basis of better methodologies or diligence'[86]. As we saw in the methodological race-to-the-

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[84] Schroeter (n 26) 384.
[85] Han Xia 'Can Investor-Paid Credit Rating Agencies Improve the Information Quality of Issuer-Paid Rating Agencies? [2014] 111 Journal of Financial Economics 2 451.
[86] Onnig H Dombalagian *Chasing the Tape: Information Law and Policy in Capital Markets* (MIT Press 2015) 82.

bottom witnessed before and after the recent Financial Crisis[87], the incentive to be diligent is arguably non-existent.

This transformation in ethos manifested itself almost immediately after the issuer-pays model was incorporated. As Moody's was the first to incorporate the model on an extensive basis, researchers have endeavoured to gauge their ratings against that of Standard & Poor's who incorporated the model in the same manner almost four years later. If, as the agencies suggest, the issuer-pays model does not affect the operations of the agencies, then the expected result of such studies would be that there would be very little noticeable difference between Moody's' ratings from 1970 onwards compared to Standard & Poor's' from the same period (given their similarities in a wide range of areas i.e. market capitalisation, resources, and rating models etc.). Jiang, Stanford, and Xie conducted this research under the title of 'Does it matter who pays for bond ratings?' and the results are spectacularly revealing. Using a sample of 797 corporate bonds issued between 1971 and 1978 that were rated by both Moody's and Standard & Poor's, the scholars find that between 1971 and June 1974, when Moody's charged issuers for bond ratings and Standard & Poor's charged investors, Moody's ratings were, on average, '*higher* than S&P's ratings for the same bond'. During the period in which both Standard & Poor's and Moody's both charged issuers for the bond ratings – July 1974 through to 1978 – the researchers find that 'Moody's ratings are *no longer* higher than those of S&P'. The scholars finish by determining that the change in the difference between the two agencies' ratings derives 'from an increase in S&P's ratings around 1974, rather than from any change in Moody's ratings'. The natural conclusion to this

[87] See the discussion on the Copula Formula in 2.3.1 *Where Loyalties Lie – The Relationship Between the Investor and the Agency* for just one example.

empirical research is that ‘this finding supports the view that the issuer-pay model leads to higher bond ratings’[88].

This incredible empirical research provides evidence to assertions of the same nature within the literature, like the OECD who state in a report that ‘the ratings inflation was attributable not to the valuation models used by the agencies, but rather to systematic upward adjustments in ratings in efforts to retain or capture business, a direct consequence of the issuer-pays business model’[89]. Although Jiang et al’s research was based on a small sample of the agencies’ history, it was the only available time-period in which there was a divergence between the two leaders of the oligopoly; the result being that any claims that suggest that the issuer-pays model is not a conflict of interest, or can be managed, can be dismissed.

Finally, one issue that stems from this understanding that the issuer-pays model inherently results in rating inflation is the systemic effect that the system will inevitably produce. Bar-Isaac and Shapiro state that several economic fundamentals suggest that ‘ratings quality is lower in booms and improves in recessions’. This systemic understanding displays for us the realisation that agencies are in effect the facilitators of economic expansion in that they primarily serve to create bubbles; their output is weaker during a time when the public interest needs it to be stronger, and then their output is stronger when there is less need for their product at all (owing to reduced investment after a burst bubble), which also has the effect of prolonging the damage that their weak output contributed to in the first place. The reason why this dynamic exists is rather simple; ‘The CRA can earn more in a boom, and so may be tempted to capitalise on the opportunity to earn the higher revenues available’[90]. It is

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[88] John (Xuefeng) Jiang, Mary H Stanford, and Yuan Xie ‘Does it matter who pays for bond ratings? Historical Evidence’ [2012] 105 Journal of Financial Economics 3 2.
[89] Organisation for Economic Cooperation and Development *Bank Competition and Financial Stability* (OECD Publishing 2011) 26.
[90] Heski Bar-Isaac and Joel Shapiro ‘Ratings quality over the business cycle’ [2013] 108 Journal of Financial Economics 62.

safe to say that at this point in the thesis we can discount the word 'may' from Bar-Isaac and Shapiro's statement.

We have seen that the adoption of the issuer-pays model irreversibly altered the dynamics within the industry so that their operations were now set up to serve the needs of their clients, the issuers, rather than the needs of their former clients, the investors. There is ample evidence that suggests the model has created rating inflation across the board, and resulted in a lack of diligence based upon the agencies' acceptance of the requirements of the issuers rather than investors. This seemingly reckless desire to garner as much revenue as possible (it is actually rather calculated) then has the effect of causing systemic issues like bubbles, which ultimately affect the general public through the reduction of societal provisions in order to meet the costs incurred by the bursting of the financial bubble ('austerity' measures for example).

Now we shall look at the last commonly-understood facilitator of the divergence which is the concept of regulatory reliance. In the 1970s the Securities and Exchange Commission purposefully integrated the agencies into the regulatory framework, which sought to give authority to the practices that were already in place within the economy (as we saw earlier large investors were already dependent upon the NCO ratings prior to the 1970s[91]). With competitive pressures resulting in the eradication of ratings quality, particularly in light of the incorporation of the issuer-pays model which promised huge returns for doing so[92], the SEC created the NRSRO position which essentially ring-fenced the ratings industry from any new competitors from that point forward. What effect would this ratification have upon the divergence? The answer to this question lies in the understanding that whatever effect it had

[91] (n 75).
[92] Bo Becker and Todd Milbourn 'How did increased competition affect credit ratings?' [2011] 101 Journal of Financial Economics 494; Jonathan R Macey *The Death of Corporate Reputation: How Integrity Has Been Destroyed on Wall Street* (Pearson Education 2013) 171.

could not be reversed; a fact which is proven by the continued growth of the industry even after the references to rating agencies were removed from every governmental regulation as mandated by the Dodd-Frank Act of 2010.

3.4 Regulatory Reliance

The third and final commonly advanced facilitator of the divergence is that a campaign by the SEC in the 1970s to incorporate the ratings of the agencies into a number of regulations was a prime cause of the agencies' shortcomings thirty years later. The period of incorporation, which saw the agencies being granted recognised status, is often cited as being the most important aspect in the development of the ratings industry, as Barth et al claim: 'How did these agencies become so pivotal? Until the 1970s credit-rating agencies were comparatively insignificant institutions that sold their assessments of credit risk to subscribers… the answer lies with the Guardians of Finance, especially the SEC, which created a climate in which it is virtually impossible for a firm to issue a security without first purchasing a rating'[93].

Yet, as our analysis so far has revealed, to attribute the rapid growth of the industry to just one element is misleading; is it really true that the SEC were the ones who created the fertile environment for the ratings industry? Alternatively, the appropriate way forward is to consider a number of aspects as part of a 'causal web', so incorporating an understanding of the oligopolistic structure of the industry or the industry's relationship with investors after the widespread release of photocopying machines all must be taken into account, amongst other aspects of course. Therefore, this section has a number of aims that fall in line with the rest of the chapter. Firstly, it will assess whether the commonly held understandings as represented

[93] James R Barth, Gerard Caprio, and Ross Levine *Guardians of Finance: Making Regulators Work For Us* (MIT Press 2012) 106.

in the literature are appropriate, because as we saw in the last section regarding the widely-held but misinforming adoption of the Penn Central hypothesis, a widely-held narrative is not automatically the correct narrative; so, the section will begin by assessing whether regulatory reliance began in the 1970s or whether that specific period of incorporation was effective only because of the other elements we have already assessed i.e. the burgeoning capital markets or the new relationship between the agencies and their new clients, the issuers.

This assessment will be helpful because many analyses seem to direct absolute blame towards the SEC[94], but understanding whether this is deserved will be important because the consequence of these claims is that blame is simultaneously diverted away from the agencies, which is particularly distasteful given their actions. To conclude, the section will assess the effects of this period of incorporation, with the result being the confirmation that the incorporation of the ratings of the agencies, and therefore the agencies themselves, when combined with their structure and remuneration model essentially cemented their position within the economy that we see today. Furthermore, not only was their position cemented, but their conduct displayed ever since was arguably inevitable owing to the ratification by the SEC (in combination with the other factors); in effect, the agencies had risen from facing extinction to being cemented within the regulations that governed access to the burgeoning capital markets, all whilst having a new remuneration model that allowed them to capture more revenues than ever before, in a period spanning just over 5 years. This incredible reversal of fortunes was the breeding ground for the divergence we witness today.

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[94] Barth, Caprio, Levine (n 93); Fight (n 66) 54; Jonathan R Macey *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2010) 115; Thierry Paulais *Financing Africa's Cities: The Imperative of Local Investment* (International Bank for Reconstruction and Development/The World Bank 2012) 49.

3.4.1 Regulatory Reliance: The Blame Game

We saw earlier in 1.4 *A Snapshot of the Regulatory Framework* that in 1975 the SEC promulgated the 'haircut' rule that also had the effect of assigning the status of NRSRO onto the Big Three (the Big Three were the only recipients initially, although two more would follow in the seven years that followed the rule promulgation[95]). However, in the same section we also saw that in the 1930s the Office of the Comptroller of the Currency officially recognised and incorporated the agencies into their regulations as well. So, in line with this it will be important to understand the concept of regulatory incorporation with regards to the ratings industry in its entirety, because assessing such an important construct in a limited manner has the potential of producing distorted and therefore misleading information. The seemingly predominant condemnation of the SEC for its actions in the 1970s is potentially dangerous in that it directs blame and attention away from other important aspects, like the nature of the industry.

Flandreau and Sławatyniec attempt to dispel the myth that before the 1970s the ratings industry was of limited importance[96]. This myth is a prime example of the effect that misguided information can have, because the reality is that the agencies were extremely important, in the context of that era, and were relied upon heavily by a number of parties, which ultimately goes against the narrative of the SEC incorporating the agencies unexpectedly and the damage caused after this therefore being the fault of regulators. It seems as if though assessments of the industry's importance stems from their involvement with the globalised capital markets, but when we understand that between 1900 and 1940 the US Judiciary *overwhelmingly* relied upon the rating agencies in commercially-concerned

[95] Gerald J Miller *Handbook of Debt Management* (CRC Press 1996) 518.
[96] Partnoy (n 2) 70.

cases because 'both banks who originated the products and those who distributed them were, *already in the 1920s*, highly dependent on the decisions of rating agencies for they benefited from the ratings being generous (as they would be able to sell more products without facing liability risks)[97], then the relevance of understanding someone's meaning behind the term 'importance' is all too apparent. So, in opposition to the claims that that revolutions occurred in the usage of ratings in the 1930s[98] or the 1970s[99], it is actually the case that they were *relied upon* by financial institutions and investors long before those eras.

As a result of this understanding it is clear that a switch in emphasis needs to occur, based upon the *actual* version of events. Whilst the common assertion is that the regulatory incorporation of the 1970s created an 'artificial demand'[100], and that essentially the industry was forced upon the marketplace, it is actually the case that the market relied upon the agencies' outputs long before an institution representing the state sought to ratify their output. If we are to assess this further, then one point that ought to be raised is that rating agencies existed, and prospered, long before the SEC was even formulated. What is important to remember is that ultimately the agencies did provide an information service that allowed investors to make informed choices, and that these services made the process of investing economically viable at a time in US history when the expansion of the territories had the potential of increasing costs for investors.

This sentiment is confirmed by Flandreau and Sławatyniec's research when they find that the courts refused to technically endorse the rating agencies, but rather confirmed their acceptance of the understanding that the ratings had become a conventionally accepted

[97] Marc Flandreau and Joanna K Sławatyniec 'Understanding Rating Addiction: US Courts and the Origins of Rating Agencies' Regulatory Licence (1900-1940)' [2013] 20 Financial History Review 3 240.
[98] Gilbert Harold is recognised as being the originator of this view, see Gilbert Harold *Bond Ratings as an Investment Guide* (Ronald Press 1938).
[99] Partnoy, in general, but particularly in (n 2) is a key component of this scholarly view.
[100] Macey (n 94) 115.

benchmark in the banking and securities trading professions[101]. It is on this basis that it is contested here that the focus that centres on the SEC when it comes to apportioning blame is not entirely justified, because just like the SEC in 1975 and the Judiciary before the 1930s, it is actually the fact that the market was dictating the acceptance of the agencies, not the regulatory bodies (the regulatory bodies can be seen to be retroactive in this light). In evaluating Partnoy's well-known but contentious principle of the SEC granting 'regulatory licences'[102], Flandreau and Sławatyniec are correct in noting that the Judiciary's understanding of the agencies' systemic importance, which was merely transferred to regulatory bodies (the OCC in 1931 and the SEC in 1975) represents a 'legal licence' rather than a 'regulatory licence'.

What this does then is shift our attention to the market. It has been stated that 'regulatory use occurred because rating agencies already were providing a well-known and valuable product to market participants'[103], which of course is true when we consider that in 1931 when the OCC incorporated technical elements of the agencies' products into their regulations, they did not have to supplement this with any explanation; the market was well aware of the agencies' products because they had been using them for over 50 years (and in some cases even longer). This calls into question then the wisdom in championing the removal of references to the agencies within regulations in the Dodd-Frank Act of 2010, because as Darbellay and Partnoy note 'behavioural reliance on ratings has been deeply anchored in the

[101] Flandreau and Sławatyniec (n 97) 246.
[102] Partnoy develops this theory, predominantly, in two works: Frank Partnoy 'The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies' [1999] 77 Washington University Law Quarterly 3; Frank Partnoy (n 2).
[103] House of Lords *Banking Supervision and Regulation: 2nd Report of Session 2008-09. Vol. 2: Evidence* (The Stationery Office 2009) 77.

financial markets'[104]. The scholars go on to ask whether behavioural reliance is the key factor driving the Big Three's market share, and the answer has to be a resounding 'yes'.

Ultimately this understanding of the *actual* version of events can help us to prepare reform proposals that are more appropriate. If it is the case that the market dictates that the Big Three remain in power, then what use is removing references within the regulations, because the investors will continue to use the agencies regardless. The actual effect, which we shall see in the next chapter, is that now the state has removed itself from the equation, superficially, investors have no recourse to complain that they were forced to use the agencies. What is important for our analysis is that the correct account of the history of the ratings industry is consistently advanced, because the account that focuses on the 1970s as the real turning point neglects over 130 years of actions that can reveal to us the true characteristics of the target for reforms.

3.4.2 The Effects of SEC Incorporation

It is important here to reaffirm that we must understand the following 'effects' of regulatory reliance in conjunction with the effects of the oligopolistic structure and the issuer-pays remuneration model, because they all form part of a 6 year campaign that has come to define the modern rating industry. This is perhaps emphasised best when we assess the effect that regulatory incorporation had upon competition within the industry. It has been noted that the incorporation in 1975 essentially made competition within the industry 'almost

[104] Aline Darbellay and Frank Partnoy 'Credit rating agencies and regulatory reform' in Claire A Hill, James L Krusemark, Brett H McDonnell, and Solly Robbins *Research Handbook on the Economics of Corporate Law* (Edward Elgar Publishing 2012) 290.

impossible'[105], but as we now know the oligopolistic structure and the requirements of those in the corporate bond market are the actual reason why competition is 'almost impossible'; at most the SEC rules served to officially ratify what was occurring already. Fight suggests that assigning NRSRO status actually allowed the US Government the opportunity to insert itself in this area that is dominated by the market and protect its own hegemonic interests: '…the defining criteria (of NRSRO status) have never been articulated by the SEC (advantageous if the goal is to block the road to foreign rating agencies!)'[106].

The NRSRO status altered the dynamics within the industry, because now rather than operating under the façade of being constrained by competitive and reputational pressures, they were purely bound by regulatory pressures, as Freidman suggests: 'their financial success did not depend on the ability of these techniques to produce accurate ratings. Instead, their profitability depended on government protection. If the rating agencies used inaccurate rating procedures, they would not suffer for it financially – let alone would they go out of business'[107]. From 1975 onwards the only real concern for a NRSRO was not losing that NRSRO status, and that was it. Again, however, an understanding of the wider picture is beneficial because the reason why this regulatory factor contributed to the degeneration of the industry's output is because of the presence of a global market that depended on rating agencies (this was not the case in the 1930s when disintermediation was not as prevalent), and also because the agencies had incorporated a remuneration model that altered the nature of the output whilst also allowing them to record incredible profits based on the operational requirements of issuers as opposed to subscribers.

[105] Paulais (n 94) 49.
[106] Fight (n 66) 54.
[107] Jeffrey Freidman 'Capitalism and the Crisis: Bankers, Bonuses, Ideology, and Ignorance' in Jeffrey Freidman *What Caused the Financial Crisis* (University of Pennsylvania Press 2011) 13.

With the regulatory pressure being the only true pressure that serves to constrain the agencies, it has been argued that the result is that agencies' outputs tend to be homogenised so that no one agency steps away from the crowd[108]; this makes sense because before the Financial Crisis the SEC would never had removed all of the NRSRO designations as a punishment (Congress did with the Dodd-Frank Act but that is another matter). This homogenisation has a systemic effect in that the uniformity in opinion increases the degree and spread of procyclicality, because a downgrade for a firm is more likely to result in multiple downgrades which would devastate their position, and if the agencies all respond to an event in exactly the same manner i.e. the response to the collapse of Lehman Brothers, then the spread of downgrades and losses is almost instantaneous[109].

Part of the reason for this uniformity, other than not wanting to draw undue attention onto a given agency, is because the agencies began to construct their ratings so that they achieved a regulatory purpose rather than represented the underlying creditworthiness of the given entity; this is particularly relevant to the structured finance market[110]. For example, the CDOs and SIVs that came to define the pre-Crisis era were all designed so that they had just enough attributes to be rated as AAA, but not enough that they reduced the profits available for the entities that created them; as a result, when the first products began to default it quickly became apparent that all of the products that had the same rating were of a similar nature, which is the reason why we saw mass downgrades in 2007 and 2008. This notion of being able to construct an offering so that it just passed the threshold for what was regulatory required was a direct result of the incorporation in the 1970s (although subsequent additions to the SEC rules affected SIVs and CDOs).

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108 House of Lords (n 103) 78.
109 Stijn Claessens and Kirsten Forbes *International Financial Contagion* (Springer Science & Business Media 2013) 443.
110 Douglas D Evanoff *The First Credit Market Turmoil of the 21st Century* (World Scientific 2009) 177.

These effects of the regulatory incorporation, the procyclicality, the official termination of competitive and reputational pressures, and the transformation of emphasis upon meeting regulation standards rather than quality standards are indeed incredible. However, one can only gauge how incredible they are by understanding that before the CRA Duopoly Relief Act of 2005, the CRA Reform Act of 2006, and the Dodd-Frank Act of 2010 the SEC received very little information from the agencies. Miller notes that the SEC often received their information on the operations of the agencies *through business publications or from competing rating agencies*: 'For example, the (SEC) learned about McGraw-Hill Inc.'s (S&P's parent company) acquisition of J.J. Kenny Co., a bankers' broker, from a *Wall Street Journal* article'[111]. This incredible understanding, when paired with the fact that there is no formal training, educational qualification, or professional qualification required to become a rating analyst[112] arguably leads to the conclusion that up until 2006 the ratings industry was, in essence, unregulated which is an incredible conclusion to reach.

The regulation of the credit rating industry is a particularly complex area to assess, and admittedly many aspects have been deferred to the next chapter where we shall assess in greater detail the regulatory response to the crisis (which incorporates an analysis of the regulatory failings that the Dodd-Frank Act attempts to remedy). What is abundantly clear from this analysis however is that the regulatory incorporation that took place in the 1970s was an important factor in the development of the industry we see today, but it was not the decisive factor; it is simply not appropriate to consider just one of the 'causes' of the failings of the industry alone.

[111] Miller (n 95) 518.
[112] Fight (n 66) 54.

3.5 Conclusion

Before the thesis can progress it was important to give as much detail as possible on this concept of there being a divergence between what is *desired* of the agencies and what they *actually* deliver. Though there are many instances that illustrate that the idealised position of the parties that surround the agencies - the state, investors, and issuers - is nothing more than a fallacy, the fact still remains that reforms have been consistently founded upon the realisation of the requirements of these idealised positions. We shall see in the next Chapter that the once-in-a-generation opportunity to enact meaningful change that the Dodd-Frank Act represented was squandered because it focused on the *desired* rather than the *actual*. The next Chapter is framed within that understanding, so in order for that analysis to be effective we first had to understand the reasons for the divergence and how they contribute to the perpetuation of it.

The Chapter began by assessing the oligopolistic structure of the ratings industry. It was established that a large majority of the perceived ills of the ratings arena stemmed from this oligopolistic structure; the agencies all follow one another with regards to rating methodologies, and perhaps most importantly their professional conduct, because an oligopolistic structure encourages a propensity to follow one another. When we consider the extraordinary dominance that S&P and Moody's have over the rest of the industry, it is clear to see that they plan to operate solely within the confines of the oligopolistic structure; to deviate and act responsibly, which would likely raise costs and reduce earnings, would see them lose substantial ground to their oligopolistic partners.

In discussing the lack of alternatives that exist to the current model, it became clear that the reason for this was not due to a lack of effort, but a lack of appetite for competition. The notion of the rating oligopoly being a 'natural oligopoly' stems from the understanding that investors determine the future of the industry, and that increased competition would in turn raise their costs and reduce the economic viability of investing; it is this understanding that sits at the heart of the problems that define the ratings industry today, because the agencies fully understand this and proceed upon the acknowledgement that they cannot be removed from their position because investors will not tolerate it. Though this understanding is related to other elements, like the state's acceptance of this understanding (the state could not allow for a reduction in systemic investment), it is the agencies' acknowledgement that determines their appalling conduct – it is not inevitable that gatekeepers in this position have to act in such a manner.

This manner was illustrated when we assessed the adoption of the issuer-pays remuneration model. As opposed to the almost passive intimations that the Penn Central hypothesis produces, we saw that the adoption of the issuer-pays model was prompted by a credible threat to their existence through the process of 'free-riding', and was ultimately facilitated by the expansion of the globalised capital markets that grew as a result of the collapse of the Bretton Woods monetary system. The international and dispersed nature of the capital markets meant that the agencies were required in order to make participation for investors economically viable. The influx of issuers to this burgeoning marketplace, combined with the fall of the commercial paper market (and therefore the NCO) provided the agencies with the perfect opportunity to incorporate the lucrative issuer-pays model; which they did emphatically.

The effect of the adoption of the model was instantaneous; Moody's, the first agency to incorporate it in an extensive manner, immediately began to cater to the issuers, now their main source of income, by way of inflating their ratings. We saw how this inflation was confirmed by studies that compared Moody's ratings to that of S&P, who for four years maintained the subscriber-pays model. S&P's eventual incorporation of the model heralded an era defined by a race-to-the-bottom with regards to quality, and most importantly ethics. This incredible situation was only made possible by the oligopolistic structure, but its success depended upon interweaving this new model into the fabric of the economy; the SEC duly followed suit in 1975.

The SEC, in incorporating the agencies into its regulations in 1975, certainly cemented the new maximising ethos of the ratings industry, and arguably cemented it irrevocably. In our assessment we saw how rather than do it maliciously, the Commission enacted the rules to implement themselves into the process that was already considered to be the standard in the economy; by determining the requirements of investors, the conduct of market participants, and the composition of the ratings industry, the Commission had attempted to implement some order in an environment in which it had no real authority – the lack of resources ultimately meant that it could not serve to protect investors on its own. However, whilst this attempt, when viewed in this light, seems perfectly rational, the *actual* version of events paints a rather different picture. In reality the Commission had incorporated an agency without knowing much about it; there was no information coming from the agencies with regards to their operations, and it appears that there was very little consideration given to the plight of the agencies. In the space of five years (six including S&P's foray into issuer-paid municipal ratings) the rating industry had gone from avoiding extinction to incorporating a model that gave them the real opportunity to make more money than was ever thought possible; for the Commission to focus upon their own needs and ignore the effects that their incorporation of the agencies would have was particularly short-sighted and proved to be an extremely damaging decision. The agencies, now free from competitive and reputational pressures, and armed with a guaranteed and exceptionally large flow of revenue, decided to take full advantage of their position which would eventually cost the global society trillions of dollars and place large parts of the world in an extremely difficult financial position for years to come.

It is on this understanding that the reform proposal that will be established in Chapter 6 operates; the ability of the rating agencies to take advantage of their position must be constrained. Whilst it is very difficult to foresee a chain of events that would result in their actual position being fundamentally altered, it is far more reasonable to suggest that by constraining their ability to take advantage of that position, by way of excessive profits from activities that are not important for the actual act of rating i.e. ancillary services, the financial penalties that are seemingly the only threat *may* have more of an impact then they do now. We shall now see in the next Chapter that this focus on the *actual* version of events was simply not considered in the wake of the Financial Crisis. In order to provide weight to the reform proposal in Chapters 5 and 6 we will have to understand where the current regulatory sentiment lies, and ultimately where it has failed.

Chapter 4 – Tried and Failed: An Assessment of the Legislative and Regulatory Response to the Industry's Role in the Financial Crisis

4.1 Introduction

So far we have been introduced to the ratings industry, discovered that it operates in a different manner to how it is expected to, and also why this is the case and how it was made possible. We have already seen on a number of occasions that the agencies continue to act in this opposing manner, even after the Financial Crisis, so now it will be important to assess the legislative and regulatory responses to their actions. However, that the agencies' conduct continues is a damning indictment of the effectiveness of this response. The reason for this is that the legislative bodies have focused upon what they *desire* the agencies to be, rather than focussing upon their *actual* capabilities as demonstrated by their actions over a long period of time; this lays at the heart of the recent legislative ineffectiveness. In examining this ineffectiveness, we shall see that what is required are incremental reforms that concentrate upon the agencies' actual philosophies and subsequent capabilities, which is precisely what follows in Chapter 6 *A Reform Proposal*.

It should be obvious that the United States was not the only country to enact major reforms in the wake of the crisis. With regards to the ratings industry, the EU enacted particularly extensive pieces of legislation after the collapse, with the first piece being the first to be established anywhere in the wake of the crisis[1]. However, for our analysis it will be important to remain focused on the United States for a number of reasons. Perhaps the most important reason is that the agencies were created, and continue to be headquartered, in the United States. Whilst the financial crisis spread around the globe (mostly in the West but there was naturally knock-on effects for the Rest of the World), it originated in the US with US-based

[1] Niamh Moloney *EU Securities and Financial Markets Regulation* (OUP 2014). For the actual Acts see Regulation (EU) No 1060/2009 [2009] OJ L302/1; Regulation (EU) No 513/2011 [2011] OJ L145/30; Regulation (EU) No 462/2013 [2013] OJ L146/1. There was also a significant Directive which contributed to the direction of CRA related regulation in the EU, Directive 2013/14/EU [2013] OJ L145/1.

institutions selling products that were primarily based upon US housing mortgages; this resulted in the US being seen as having to take the lead with regards to regulation. Also, the nature of the EU means that different factors are important in comparison with the US, which may alter their focus when regulating the ratings industry. One clear example of this would be the rating agencies' involvement in the sovereign debt crisis that still has the EU in a state of flux[2].

So, we will start by assessing the relevant sections of the US's legislative response (The Dodd-Frank Act of 2010). It will then be important to detail some of the issues that have arisen from the Dodd-Frank Act, particularly with regards to the administering of its rules and guidance, which is a real issue with this piece of legislation. The Chapter will then use these analyses to make a judgement on the effect the Dodd-Frank Act has had in relation to the *desired v. actual* framework. The consequences of this will be important for the projection of potential validity for the reforms proposed by this thesis later on.

4.2 The Dodd-Frank Act of 2010 – What Were its Aims?

As we have heard throughout the thesis, the US responded to the financial crisis by enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. In its preamble the Act states that its aim is to 'promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes'[3]. For our analysis the most important

[2] For more on the EU Sovereign Debt crisis and the agencies role in it see Lucia Quaglia *The European Union and Global Financial Regulation* (OUP 2014).
[3] *The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* 124 Stat. 1376.

section of the Act is Title IX 'Investor Protections and Improvements to the Regulation of Securities' - Subtitle C 'Improvements to the Regulation of Credit Rating Agencies'. This expansive section aims to readdress certain elements, and ultimately build upon both the Securities and Exchange Act of 1934 and the Credit Rating Agency Reform Act of 2006 with respect to rating agencies.

It has been noted by various onlookers that the Act has nine particular areas that it covers with respect to the ratings industry. It aims to legislate in the areas of: SEC oversight; governance and compliance; conflict of interest management; accountability for ratings procedures; transparency of ratings procedures and methodologies; the use of ratings within statutes and regulations; SEC-provided penalties; Securities Act registration, and finally the Private right of action[4]. Before we continue it is appropriate to note that from this cursory review the Act appears to be challenging the constructs that make up the *actual* in order to bring about the *desired* as much as possible; however, does this understanding hold up under closer inspection?

Congress was of the opinion that the SEC required more power in this area than it had been granted in the CRA Duopoly Relief Act of 2005 and the CRA Reform Act of 2006. Whilst it is to be expected that Congress appointed the SEC as the State's representative in such matters, given its position within the regulatory framework since its inception in 1934, it is apparent that a lot of the Act leaves *making* the rules and *enforcing* those rules to the SEC; the Act simply dictates on a number of occasions that the SEC takes action. This will be discussed in the next section as this element of the Act raises a number of concerns, although

[4] Claire A Hill 'Limits of Dodd-Frank's Rating Agency Reform' [2011] 15 Chapman Law Review 1; Jeffrey Haas *Corporate Finance* (West Academic 2014).

for now it appropriate just to note that the SEC is placed at the forefront of ratings industry reform by the Dodd-Frank Act[5].

All of the elements of the Act are important, although some are crucial to the deciding of the course for the industry and the effects that that may have. With regards to the *actual*, there are a number of the stated aims of the Act that aim to change or restrict the *actual*, in theory. Perhaps the most noteworthy attempt comes in the form of Congress attempting to remove the systemic reliance upon the agencies by removing the references to them within statutory and regulatory documents. Again, in deferring the particular details to the respective agencies, the Act instructs those governmental agencies that have historically used the ratings as a standard measure of creditworthiness to 'remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations'[6]. Macey has noted that, in theory, this act of removing statutory reliance forces investors (particularly institutional investment managers) to analyse investments by taking into account a variety of information and not to lean upon the agencies, which leads to the reduction of systemic risk by 'decreasing the tendency of mutual funds to have investments that are highly correlated with (i.e. the same as) the investments of other mutual funds'[7]. It is worth noting to avoid any confusion that the Act merely states that ratings cannot be the *only* declared source of investment guidance used by investment managers. The effect of this is negligible as we shall see, as we already know that the larger investors incorporate ratings *into* their analysis rather than relying upon it; what it does change however is the dynamics of the agency

[5] Aline Darbellay and Frank Partnoy 'Credit rating agencies and regulatory reform' in Claire A Hill, James L Krusemark, Brett H McDonnell, and Solly Robbins *Research Handbook on the Economics of Corporate Law* (Edward Elgar Publishing 2012) 280.
[6] *The Dodd-Frank Act of 2010* (n 3) § 939A (b).
[7] Jonathan R Macey 'The Nature and Futility of "Regulation by Assimilation"' in Greg Urban *Corporations and Citizenship* (University of Pennsylvania Press 2014) 217.

problems we have discussed in that shareholders cannot use the ratings as the only benchmark in which to constrain the decisions of managers.

Another aim of this particular order is to reduce the availability of the state-induced crutch for investors, but also to force the agencies to compete ‘on the basis of the quality of their ratings as the artificial demand for their services created by regulation subsides’[8]. This concept raises all of sorts of problems as it brings into the equation the notion of ‘competition’, which due to the dynamics of the industry is very difficult to realistically induce as we know. Macey also suggests that this move will lead to the ironic situation of the agencies’ quality improving just as their relevancy decreases[9], although this notion is particularly representative of an attempt to move the situation into the realm of the *desired* whilst not taking into account the *actual*; as we shall see the agencies have lost none of their ‘relevancy’.

The other crucial part of Subtitle C was Congress going against vast amounts of judicial precedent and established practice by making the agencies liable for their ratings. Congress deemed the agencies’ operations to be commercial in nature and that they were to be held to the same professional levels of accountability as registered public accounting firms or securities analysts under the securities laws[10]. The Act states that in order to make a claim for damages emanating from a credit rating the plaintiff must be able to prove that the credit rating agency ‘knowingly or recklessly failed… to conduct a reasonable investigation of the rated security with respect to the factual elements… (and/or) to obtain reasonable verification of such factual elements’[11]. It is for exactly this reason that CalPERS settled with Fitch for important and incriminatory documents rather than money; the documents allowed CalPERS

[8] ibid.
[9] ibid.
[10] *The Dodd-Frank Act of 2010* (n 3) §933 (a)(m)(1).
[11] ibid (B).

to *prove* the 'state of mind' of Standard & Poor's (it is assumed that it will be able to do so for Moody's as well)[12].

These are indeed the key elements, although it will be useful to briefly go through the other elements as they will be assessed when we look at the potential issues with the Act. There are a number of references to the internal organisation of the agencies and the responsibilities which must be met. For example, half of the Board at an NRSRO must now be independent (at least half, and a minimum of 2). The agencies must now also publish their methodologies that have been used in formulating a rating, and that methodology must be used across the entire class of ratings, or the rating agency must publish the reasons for not doing so. The agencies are also prohibited from using universal rating symbols to avoid the confusion over the structured finance ratings as discussed earlier[13], whilst they are also forced to prove they have considered more information to produce their ratings other than that provided by the issuer. Also, they are now obliged to inform Law Enforcement authorities when they become aware of the issuing company acting (or to have acted) in a manner that is deemed illegal for whatever reason; this has the real effect of altering their role within the framework because as we saw the agencies are adamant that they are not in the business of detecting fraud[14].

As was stated earlier the SEC have been given more powers and with it much more responsibility. They must check that the agencies are keeping to prearranged conditions designed to separate sales and marketing influences from the credit rating process, in addition to checking the increased amount of declared documentation from the agencies that has been mandated by the Act. In terms of their capability to enforce the rules of the Act, the SEC has now been given the power to suspend or revoke an NRSRO's licence or suspend it from a certain area of ratings (which it has done with relation to S&P and Egan-Jones as we have

[12] 2.2.1.1.2.3 *The Case of CalPERS*.
[13] 1.4 *A Snapshot of the Regulatory Framework* (n 127).
[14] 1.3 *The Industry: What It Does* (n 60).

already seen). The SEC was also instructed to create an 'Office of Credit Ratings' that was to be at the epicentre of its relations with the agencies.

On paper these steps are admittedly a positive step in countering the distasteful practices of the agencies and the issuers who they were in cahoots with (the Dodd-Frank Act covers almost every aspect of the pre-crisis system). It appears that the Act has managed to focus on the *actual* more than the state ever has, at least since the New Deal era, to achieve the *desired*. However, if this was the case there would be very little criticism, as the *desired* is seemingly widely coveted. Yet, it has been claimed that the reforms are directed at the *symptoms* rather than the *causes* which has had the effect of altering the façade rather than the structure[15]. If the Act was successful in its mission, then the oligopoly would have been dismantled, the rate of profit and revenue would have decreased, and the financial sector would have been weaned off of its 'addiction to ratings'[16]; this has simply not been the case. To understand why, it is important that we turn our attention to the many criticisms of that Act and the way in which its legislative rulings have been administered.

4.3 A Reality Check

The stated aims of the Act are very honourable indeed; they certainly appear to generate the required safeguards that would have prevented the financial crisis had they been in place. However, it should be very clear at this point in the thesis that the ratings industry represents a unique realm within which there are a number of dynamics that are constantly swinging the balance of power in favour of the agencies. The benefit of hindsight tells us that the agencies

[15] Darbellay and Partnoy (n 5) 286.
[16] Marc Flandreau and Joanna K Sławatyniec 'Understanding Rating Addiction: US Courts and the Origins of Rating Agencies' Regulatory Licence (1900-1940)' [2013] 20 Financial History Review 3.

have become *more powerful*, have maintained their status as an oligopoly (or duopoly), and have *increased* both their revenues and profits, all whilst seemingly adhering to the new rules put in place that are designed to do the very opposite. This naturally leads one to suspect that these rules that have been designed to do the very opposite have in actual fact been incorrectly designed, otherwise the post-crisis successes of the agencies would not have been witnessed, theoretically.

The Dodd-Frank Act has been widely criticised from a number of different perspectives[17], which is to be expected when such extensive reforms are enacted; the New Deal reforms were also criticised in the wake of their enactment[18]. However, for our analysis it is important to look at two particular aspects. Firstly, we need to establish what the effects of the rules have been in reality, and secondly, we need to understand the complexities involved in transferring those rules from the pages of the statute to the everyday running of the financial sector. If the intended effects are different to the effects of the *actual*, then there are two potential explanations for this; either the legislators have mistakenly interpreted the *actual* dynamics of the ratings industry and all that comes with that, or the legislators have mistakenly interpreted the dynamics of the regulatory framework that governs the ratings industry.

To begin with the issues surrounding the interpretation of the industry itself, one commentator has noted that in aiming to remove the reliance upon NRSROs and making them more accountable, the Dodd-Frank Act has actually served to empower The Big Three and disadvantage its 'competitors'. Pierce argues that the requirements relating to

[17] The criticisms of the Act come from literally every affected aspect of the financial system, whether it is rating agencies, banks, insurers, or a number of other financial sectors. For just some resources that are representative of the sentiment aimed at the failings of the Act see Christian Evans 'The Dodd-Frank Wall Street and Consumer Protection Act: A Missed Opportunity to Rein in Too-Big-To-Fail Banks' [2011] 13 Duquense Business Law Journal; Hill (n 4); Edward J Kane 'Missing Elements in US Financial Reform: A Kübler-Ross Interpretation of the Inadequacy of the Dodd-Frank Act' [2012] 36 Journal of Banking & Finance.

[18] Burton W Folsom *New Deal or Raw Deal?: How FDR's Economic Legacy Has Damaged America* (Simon and Schuster 2009) 219.

organisational structures and internal governance are disproportionately burdensome for the smaller agencies[19]. Pierce does acknowledge however that the SEC has been granted powers by the Dodd-Frank Act to exempt smaller agencies in the name of reducing the burden that comes with adhering to the Act, although he does have reservations about whether the SEC will use these powers. Since 2013 when Pierce's work was published, the SEC has granted exemptions to four NRSROs when it concerned being excluded from the marketplace as a result of adhering to the new requirements[20], although one agency did relinquish its NRSRO status in the wake of the Dodd-Frank Act being implemented[21].

Whilst the concept of disproportionality seems to have been negated by the Act with regards to the potential burdens in adhering to the Act for the smaller agencies, what it has not countered is the disproportionate effect the opening of liability may have on the smaller agencies. Pierce makes the valid argument that the larger NRSROs (The Big Three) have specialised legal departments *devoted* to repelling legal actions, whereas the smaller agencies are less able to defend themselves[22]; it is certainly true that the Big Three have much more experience of repelling legal action against their conduct. Also, the larger agencies have the capacity to absorb any fines levied against them, mostly because of their vast size and compartmentalised sources of revenue (this is yet another of the major issues with Ancillary Service Provision).

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[19] Hester Pierce 'A Title-by-Title Look at Dodd-Frank: Title IX – Securities and Exchange Commission' in Hester Pierce and James Broughel *Dodd-Frank: What It Does and Why It's Flawed* (Mercatus Center at George Mason University 2013) 102.

[20] The SEC granted temporary exemption to MorningStar, LACE Financial Corporation, and Kroll Bond Rating Services. MorningStar applied for an exemption as their planned switch to the issuer-pays system would have seen them violate certain aspects of the Act. Kroll applied in order to be able to expand their operations into CMBS markets. LACE applied because they had ratings outstanding on a client who provided more than the permitted 10% of total revenue (which is clearly more of a concern to smaller agencies than the Big Three). The SEC also granted exemption to Japan Credit Rating Agency, although this was to ensure that they complied with regulatory requirements regarding board structure in the US and well as Japan, see the following for the respective SEC Releases: Securities and Exchange Commission *Release Nos. 34-71219; 34-71220; 34-57301; 34-75747*.

[21] Rating and Investment Information, Inc. (R&I) withdrew on October 13th 2011, stating that the withdrawal was 'based on its own business judgment' see Rating and Investment Information, Inc. 'R&I to withdraw from NRSRO registration with USSEC' [2011] R&I News Release.

[22] Pierce (n 19) 103.

If we look more closely at what the Act is asking the agencies to do, then Hill's perception that 'Dodd-Frank does not ask rating agencies to guarantee results, only processes'[23] is particularly astute. This adds weight to the notion that the legislators have failed to learn from, what we now understand because of the analysis in Chapter 2, the actual conduct and processes of the credit rating agencies, because as Hill argues 'the essential conflict, that the issuer is the client, remains, no matter what formal separations of duties and outside monitoring is mandated[24]'. If we accept this understanding then Hill's argument that the Act will serve to perfect concealment rather than quality is logical, given that the core of the agencies' business is to cater for their clients, which as we know are the issuers of the securities they rate. It is fathomable to suggest that the agencies will now invest heavily in working out how to navigate their way through the restrictions imposed by the Act so that they can enable the issuers to take profitable securities to the marketplace; or perhaps they, and the issuers will bide their time before the collective amnesia takes hold again and deregulation becomes acceptable.

In the same vein as Hill, Pagliari argues that the Act has only sought to intervene in the façade and has avoided altering the *actual*. Pagliari has a particular concern regarding allowing the agencies to dictate their methods and only having to declare their practices in the name of transparency. Although the sentiment of this thesis is slightly different, it is similar to Pagliari in that it is this trust in the agencies to perform in the correct manner which is at the heart of the divergence. For Pagliari, the real issue lies in the regulators' reluctance to intervene in determining the models to be used by the agencies despite their obvious shortcomings[25]. He suggests that reason for not doing so is that regulators, and the state in

[23] Hill (n 4) 145.
[24] ibid 146.
[25] Stefano Pagliari 'Who Governs Finance? The Shifting Public-Private Divide in the Regulation of Derivatives, Rating Agencies and Hedge Funds' [2012] 18 European Law Journal 1 56. See also Nicholas Ryder *The Financial Crisis and White Collar Crime: The Perfect Storm?* (Edward Elgar Publishing 2014) 65.

general, are reluctant to be seen as validating the operation of the agencies, as this would be seen to be ‘creating moral hazard and exacerbating over-reliance on ratings’[26]. This is obviously a valid concern and a positive stance to take, although whilst they may not intervene for these reasons, is it actually the case that the Act has managed to avoid such negative consequences?

In reality the Act has created a wonderfully confusing dynamic that is not helpful to society whatsoever. The Act removes all reliance on the agencies for a number of reasons, but some are more obvious than others. Yes it removes the ability of investors to rely on the ratings and claim that they were forced to use them when times turn bad, because when investors make this argument they are essentially making the argument against the state, for creating the environment in which the agencies were formally forced upon the market, although as we know the market was using the ratings anyway. However, Pierce argues that giving the SEC the ability to suspend or revoke registration sends the message that the ratings industry and its outputs have a ‘government imprimatur’[27]. This is obviously in direct contradiction to the stated aims of the Act.

This process is an important one and has been reviewed by two scholars who label it the ‘Emperor’s Equivocation’[28]. Scalet and Kelly claim that the ability to ‘pass the buck’ was institutionalised in the system that preceded the crisis, in that the state forced investors towards the agencies who expressly denied responsibility for their actions[29]. However, this notion of the institutionalisation of the ability to ‘pass the buck’ has arguably been reinforced by the Dodd-Frank Act, in that the state now have removed themselves, on the face of it at least, from the ratings process, whilst the agencies can argue that investors are not forced to

[26] ibid.
[27] Pierce (n 19) 103.
[28] Steven Scalet and Thomas F Kelly ‘The Ethics of Credit Rating Agencies: What Happened and the Way Forward’ [2012] 111 Journal of Business Ethics.
[29] ibid 488.

rely upon their ratings. The issue with the state removing itself from the ratings industry problem is that this does not take into account that the state has been systematically embedding the agencies into the fibres of the economy for over 35 years before the Dodd-Frank Act was enacted[30] (and even more so when we consider the early stages of the credit reporting and credit rating industries[31]). This alludes to the existence of a regulatory 'sleight of hand' which is just one worrying aspect; these criticisms reviewed in this section all point to the notion of the state only chipping away at the façade of the *actual* in the name of chasing the *desired*, when in reality they have strengthened the *actual* and distorted the reality of the ratings realm even further. Before we conclude however it is important to ask how this has been done. Every Act must be enforced, so whether the intentions of the legislators are honourable or not is irrelevant if there are issues with the administering of their decisions, and as we shall now see there a number of concerns regarding the vehicle for the Dodd-Frank Act's rules; the SEC.

It would be misleading to suggest that the legislative process ends with the signing of an Act of Congress into Law. Arguably, this represents just half of the whole process because, as the post-Act dynamics develop, affected parties will seek to minimise the effect that the democratically created legislation will have upon their organisation. Kane suggests that 'during and after the extended post-Act rulemaking process, decision makers will be opportunistically lobbied to scale back consumer benefits and to sustain opportunities for extracting safety-net subsidies'[32]. Macey agrees, stating that 'the rating agencies have begun a guerrilla campaign of behind-the-scenes lobbying to weaken the Commission's efforts to

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[30] Manns agrees with this sentiment in that the escalation of the reliance on the agencies by governmental bodies has 'survived the abolition of these requirements', see Jeffrey Manns 'The Sovereign Rating Regulatory Dilemma' in Nigel Finch *Emerging Markets and Sovereign Risk* (Palgrave Macmillan 2014) 132.
[31] Flandreau and Sławatyniec (n 16).
[32] Edward J Kane 'The Expanding Financial Safety Net: The Dodd-Frank Act as an Exercise in Denial and Cover-Up' in Susan M Wachter and Marvin M Smith *The American Mortgage System: Crisis and Reform* (University of Pennsylvania Press 2011) 274.

carry out other parts of Dodd-Frank'[33]. Concerned onlookers have endeavoured to chart the amount and extent of lobbying within the United States and have found that the Financial Sector lobbies more than any other sector, and that rating agencies are key members of that movement[34]. This is the first stage of the post-Act response that was to be expected. However, the important question is whether this pressure from the financial sector paid dividends? Some evidence regarding the SEC's administering of the Dodd-Frank's instructions paints a particularly damning picture.

Macey asks the question 'is the SEC simply "Captured" or is it suffering from "Stockholm Syndrome" too?'[35] He asks this question mainly because of one act of the SEC which resulted in the dilution of the Dodd-Frank Act's aims almost immediately. Barnett describes how on July 21st, 2010, President Obama signed the Act into law; the very same day S&P, Moody's, and Fitch all asked that their ratings not be used in any new bond sales[36], in direct response to the increased exposure in liability. To digress for one moment, this chain of events is indicative of the state not focusing upon the *actual*, because this act by the agencies was their obvious 'joker in the pack' and they did not hesitate to use it. This understanding can be important for us later because it is becoming apparent that when making (or attempting to make) changes to the ratings industry, one must attempt to anticipate the reactionary moves the agencies will make and attempt to counter them first; this is admittedly not a simple task.

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[33] Jonathan R Macey *The Death of Corporate Reputation: How Integrity Has Been Destroyed on Wall Street* (FT Press 2013) 232. See also Michael Lounsbury and Paul M Hirsch *Markets on Trial: The Economic Sociology of the U.S. Financial Crisis: Part A* (Emerald Group Publishing 2010) 91 for more on the financial sector's lobbying efforts after the Dodd-Frank Act.
[34] The highest spending lobbying client in the US between 1998 and 2015 has been the US Chamber of Commerce at $1.16 billion, two-thirds more than the closest client the American Medical Association. For more on the lobbying statistics, see the Centre for Responsive Politics.
[35] Macey (n 33).
[36] Harold C Barnett 'Risk and Mortgage-Backed Securities in a Time of Transition' in H K Baker and Greg Filbeck *Investment Risk Management* (OUP 2015) 418.

To continue, this removal of their ratings had the effect of bringing the entire market for Asset-Backed securities to a standstill. In response, the SEC established another of their infamous 'no-action letters'[37] in which issuers were informed that the SEC would not bring enforcement actions against them if they did not disclose ratings in the prospectuses. The result of this was that the expert-liability that the Dodd-Frank Act had sought to establish for the agencies was immediately obliterated because the ratings were no longer attached overtly to the securities on offer (although the ratings were available from a number of other sources of course). This act of removing this feature that had been championed by the Act was consolidated when the SEC 'subsequently extended this non-enforcement stance indefinitely'[38].

The issue here is that the legislators behind the Dodd-Frank Act made a crucial mistake when formulating the Act. They left a number of important issues too vague, and allowed for a lot of autonomy on the part of the SEC. When we understand that the SEC has been chastised for its part in the pre-crisis era[39], it is a very questionable strategy indeed entrusting that same organisation with the administering of such a crucial Act (what the alternative is however is hard to say). It has been noted that the Act prescribes that the SEC had to adopt a number of rules to govern various aspects of the rating agencies' operations without detailing how the SEC was to obtain the necessary expertise to carry out this mandate effectively[40], and that ultimately 'the Act provides regulators with significant room for interpretation and implementation'[41]. Subjectivity in this domain is a particularly dangerous concept.

[37] See 1.4 *A Snapshot of the Regulatory Framework* (n 105) for the use of this method in creating the reliance upon agencies in 1975.
[38] Barnett (n 36).
[39] Thomas J Schoenbaum *The Age of Austerity: The Global Financial Crisis and the Return to Economic Growth* (Edward Elgar Publishing 2012) 166; Mehmet Odekon *Booms and Busts: An Encyclopedia of Economic History from the First Stock Market Crash of 1792 to the Current Global Crisis* (Routledge 2015) 734.
[40] Jerry W Markham *A Financial History of the United States: From Enron-Era Scandals to the Great Recession* (Routledge 2015) 729.
[41] Darbellay and Partnoy (n 5) 286.

It is dangerous because as Macey suggests, the SEC is particularly vulnerable to being 'captured'. Earlier we spoke of the 'revolving door' theory[42] and this is particularly relevant when talking about the relationship between the SEC and the Rating Agencies. Firstly, the Dodd-Frank Act has (probably unwittingly) increased the potential for this to occur with the forced establishment of the Office of Credit Ratings. If we accept Macey's perception that 'the major credit rating agencies are a significant source of support and employment for SEC alumni'[43], then forcing a dedicated number of SEC staffers to be the focal point for SEC-CRA relations is obviously not ideal. The SEC's nonchalant attitude towards to the Office of Credit Ratings in the wake of the Dodd-Frank Act (the Office remained unstaffed for 12 months[44]) also paints a worrying picture of its approach to fulfilling its mandate.

Before this section concludes it will be useful to analyse just one example of the SEC's favourable approach to the Big Three, an example which also throws further light on events first described in Chapter 2. In section 2.3 we heard how Egan-Jones Rating Company had been punished by the SEC for making misrepresentations in its application to become a NRSRO[45]. However, with what has been alleged against the SEC, with regards to its potentially favourable approach to the Big Three, this event needs to be reassessed. Macey is a strong critic of the SEC and he pulls no punches in admonishing the SEC in this instance. He tells us that the story between Egan-Jones and the SEC began in 2008, when under pressure from Congress to increase competition within the ratings industry the SEC 'grudgingly' allowed Egan-Jones to receive the NRSRO designation. However, in 2012 the SEC announced that it was suing Egan-Jones and would be attempting to remove its NRSRO status. Macey argues that in suing this relatively small agency (it had at the time just 20 employees) the SEC demonstrated its 'pure maliciousness' towards the competitor to the Big

[42] See 2.3.2.3 *Mechanistic Importance* (n 170).
[43] Macey (n 33).
[44] Darbellay and Partnoy (n 5) 280.
[45] 2.3 *The Actual Situation* (n 42).

Three[46]. It is worth noting at this juncture that Egan-Jones is the only NRSRO that does not use the issuer-pays compensation model and is forthright in its promoting the understanding that it is more accurate and timely in administering its ratings than any other agency as a result. This is an important factor as we shall now see.

Macey continues by alleging that Egan-Jones' problems began in July 2011 when the company had downgraded the US' sovereign debt rating by one notch; the SEC contacted the agency immediately to ask for explanation for its decision. 3 months later the SEC notified the firm that it was the target of an investigation, and in April 2012 legal proceedings began against the agency and its co-founder Sean Egan. However, the content of this legal action is where the true nature of the SEC begins to appear. The action was not concerned with its ratings, methodologies or professional conduct (as they should have been with the Big Three), but it was concerned with a technical element of the firm's NRSRO registration. The main question surrounded the issue of whether the agency met the SEC requirement that the ratings be 'disseminated publicly', which as we know now is a laughable idea because the Big Three put their full and easy-to-use ratings and ratings decisions behind pay-walls[47]. The obvious issue here is that Egan-Jones *cannot* publicly disseminate their ratings because not doing so is how they make money; it is inherent within the subscriber-pays model that people must pay to view the ratings. In essence then Egan-Jones was punished predominantly because it had not incorporated the conflict-of-interest-inducing system of issuer-pays, which is an extraordinary understanding. For daring to do so, Egan-Jones was banned for 18 months from rating any Asset-backed securities.

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[46] Macey (n 33) 232-5.

[47] See 3.3.1.2 *The Impact of Technological Advancement* (n 78) for Langohr and Langohr's assessment of the availability of credit ratings.

4.4 Conclusion

As the presence of a divergence between the *desired* and the *actual* was established earlier in the thesis, this Chapter endeavoured to identify the regulatory response to the financial crisis for the purpose of placing that response within the *desired vs. actual* framework. Before this analysis started it was always clear where the regulatory response would fall with regards to this framework simply by analysing the trajectory of the ratings industry post-crisis. That the Big Three have resumed their pre-crisis rates of growth both in terms of revenue and profit, that their position as an oligopoly has been strengthened, and also that the major threats to their existence that were advanced post-crisis have been circumvented (liability concerns), all contribute to the realisation that the regulatory response did not take aim at the *actual* state of affairs. In essence the legislators sought to move the industry towards the *desired* by aiming at the middle ground, which inevitably has resulted in failure and the widening of the divergence. In addition to this, we now see that the state has managed to exonerate itself from any future blame even though the system that it was responsible for creating has not changed; this is a worrying development within the financial sector.

One of the main sentiments of this thesis is that *effective* regulation must seek to focus on the *actual* first in order to accurately describe what the *desired* can be and then whether that situation can be achieved. The regulatory response to the crisis has not done this; what it has done is place the onus (and future blame) on investors, whilst also absolving issuers. It has paid lip service to holding the agencies accountable for their actions, as the administering of the legislative rules have gone on to confirm (almost immediately after the Act was enacted). We saw how the SEC is playing a particularly central role in determining the trajectory of the ratings industry, which goes against its mandate to protect investors. The increased exposure of the agencies for liability was a welcome start, but as we saw the SEC's no-action letters put a stop to that development, which is particularly worrying because it is entirely reasonable that the agencies will be much more careful in the future with regards to leaving trails; the requirement to prove the 'state of mind' of the agency will prove to be very difficult, as not every investor will be able to do what CalPERS did and turn one agency against another.

Admittedly this chapter leaves a sour taste. It is contested here that the once-in-a-generation opportunity to enact socially-impactful reforms has been scuppered by the presence of captured administrators, which results in the understanding that proposing any sort of socially beneficial reforms *and have them come to fruition* is a difficult concept in itself. However, whilst accepting defeat in this endeavour may be rational, it is important to advance proposals that may educate people to the *reality* of the situation, however unlikely it may be to see it realised. In proposing that the rating agencies be forced to choose between Ratings Provision and Ancillary Service Provision, the thesis aims to both present a socially beneficial solution to the exploitative nature of the ratings industry and its ability to absorb any punishment *whilst also* developing the narrative that this reality exists; this is perhaps the key point to reform proposals regarding such seemingly immoveable objects. This thesis has, so far, established that narrative; what is important now is that the reform proposal is introduced. However, in order to do so we will need to know much more about the division that is the target for that proposed reform, and precisely why it needs to be removed.

Chapter 5 – The Issue of Ancillary Service Provision

5.1 Introduction

'Ancillary Services' is a term used loosely to describe services that credit rating agencies offer in addition to their rating services. While the actual definition of what these services are has not been definitively established[1], Moody's has defined their offering as including services such as: 'Cashflow Models; Credit Models; Pool, Loan, and Performance Data; and Valuation & Advisory Services'[2]. Yet, whilst the definition of what ancillary services actually consist of may be undecided, what is very clear is that the revenue from ancillary service provision represents a significant portion of the agencies' overall revenue, whilst it is also recognised that the provision of additional services within such a systemically important sector is very controversial[3]. It is this controversial, yet substantial, growth of a business that is not important to the development of accurate credit ratings that is at the heart of this chapter's analysis.

There has been a movement since the Crisis to reduce the influence of ancillary service provision upon the rating process, but it is important to cover the nuanced details of this movement before we continue. Essentially, no NRSRO is prohibited from providing 'ancillary services', which is more accurately represented by Moody's when they affirm that 'Moody's Investor Services (MIS) does not *currently* offer Ancillary Services *but may do so in the future*'[4]. What they are prohibited from offering is pre-rating advice to an issuer, as detailed by the SEC: 'Paragraph (c)(5) of Rule 17g-5 prohibits an NRSRO from issuing or maintaining a credit rating with respect to an obligor or security where the NRSRO or person associated with the NRSRO *made recommendations to the obligor or the issuer, underwriter,*

[1] Raquel G Alcubilla and Javier R del Pozo *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (OUP 2012) 145.
[2] Moody's Analytics *How Do You Transform Risk into High Performance? An Overview of Moody's Analytics* (2015).
[3] Aline Darbellay *Regulating Credit Rating Agencies* (Edward Elgar Publishing Limited 2013) 122.
[4] Moody's *Policy for Ancillary and Other Permissible Services: Compliance* (Moody's 2013) (emphasis added).

or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security'[5]. The aim of this regulation was to stop the process detailed earlier where agencies were involved in the construction of SIVs[6], in what was just one example, which is commonly referred to as the agencies 'rating their own work'. Whilst Moody's do not offer 'Ancillary Services', they do offer more than 17 services that it describes as 'other permissible activities'[7]. So, whilst pre-rating services are prohibited, the provision of ancillary services moreover contributes greatly to the Big Three (and the Big Two in particular).

So, in light of these factors it will be important to state some important aspects that this analysis will be built upon. Firstly, the term 'Ancillary Services' is used here to mean any service offered by a CRA which is not expressly attached to their service of credit rating provision, and is not available to issuers before a credit rating of a particular security has been disseminated, should that entity require an issuance to be rated (as that practice has now been prohibited). The second aspect that needs to be established is that there will be a noticeable favouring in analysing Moody's Analytics over S&P Capital IQ; this is solely because the data for Moody's Analytics is readily available with Moody's being a publicly traded company, as opposed to S&P being part of the McGraw-Hill company (the same applies to Fitch Ratings).

In terms of the aims of this chapter, the analysis will begin with an examination of the vehicles that deliver ancillary services, namely Moody's Analytics and S&P Capital IQ.

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[5] Securities and Exchange Commission *Final Rule Analysis – Securities and Exchange Commission Release No. 34-72936; File No. S7-18-11* (2014) footnote 70 (emphasis added). This sentiment is also the one adopted by European regulatory authorities, see Alcubilla and del Pozo (n 1) 147.

[6] See 2.3.1.1 *Collusion* and the analyses of the SIVs that the CRAs were a part of.

[7] Moody's makes clear that it does not offer consultancy or advisory services to rated entities (in addition to 'Ancillary Services'), but does offer only 'Credit Rating Services and "Other Permissible Services"', which include, but is not limited to: Bond Fund Ratings; Common Representative Quality Assessments; Equity Fund Assessments; Indicative Ratings; and Rating Assessment Services. See Moody's *Rating Symbols and Definitions* (Moody's 2016) for further details of their offerings.

Rather than examining what the ancillary services actually are and how they are utilised by the market, which is an issue that will be raised in 7.1 *Avenues for Future Research*, it will be more appropriate here to assess these subsidiary components and their contribution to the parent company's financial position overall. One of the key contentions of this thesis is that the agencies understood intently the environment that surrounded them in the early 2000s and, therefore, took the conscious decision to *take advantage* of their unique position that was protected by the State and was central to the burgeoning securitised issuance market. To test this hypothesis the Chapter will make use of figures that chart the rise of securitised product issuances, the acquisition trends of the Big Two, and the growth of Moody's Analytics in comparison to the economic fluctuations that took place in the 2000s (because financial performance figures are available throughout the period for Moody's Analytics); what we will see is that the Big Two (S&P predominantly, although the duopolistic nature of the industry means the other company will surely follow suit, which Moody's did) took notice of the demise of the consultancy operations of the leading Public Accounting Firms in the wake of the Enron and WorldCom affairs and sought to merge the same exploitative ideal with their particularly unique position – whilst Arthur Andersen would fail and PwC, Deloitte, and others would have to divest their consultancy operations, the Credit Rating Agencies would cause more havoc than was witnessed during the Enron scandal *whilst* instituting an ancillary business that has become widely accepted by regulators as just being part of the service.

In order to make this central point the chapter will then progress onto an assessment of the varying levels of criticism aimed at the agencies with regards to the provision of ancillary services. We shall see that the majority of criticism is concerned with the effect that the provision has, or at least *potentially* has, upon certain relationships (issuers being pressured into paying for additional services to preserve a rating for example), which is argued here misses the larger and more impactful point of serving to increase the divergence established earlier by way of protecting the agencies. However, the criticisms are far from incorrect, and in adjoining them with analyses that are concerned with the concept of ‘economic rent’, we shall see that ancillary service provision is as responsible for the agencies’ capacity to act in such a reckless manner than any other recognised aspect (the issuer-pays remuneration model for example); the establishment of non-vital business divisions, that are the manifestation of the agencies’ acknowledgement of their protected and influential position, has resulted in a revenue stream that is excessively increasing their capacity to absorb the only deterrent that authorities deem appropriate i.e. financial penalties.

What becomes apparent is that once again the focus has not been on the *actual* environment because, as we shall see, many of the conflicts of interests inherent within the provision of ancillary services still remain after the regulatory fertile post-Crisis era, and the fact that they have not been addressed has only served to strengthen them further. It will be on this basis that the thesis will progress onto Chapter 6 *A Reform Proposal* and establish a reform proposal that can definitively end those particular conflicts once and for all.

There are not many, if any, direct calls for the prohibition of ancillary services like this thesis is suggesting[8], and in fact some, rather incredibly, suggest that ancillary services are a

[8] With regards to the prohibition of ancillary service provision by rating agencies, there are very few proposals. In addition to any fleeting musings that appear within analyses, perhaps the only distinct call in the literature comes from a General Counsel in his testimony to the U.S. House of Representatives (which demonstrates the scarcity of this viewpoint in the literature), see Testimony of Gregory W. Smith, General Counsel, Colorado Public Employees’ Retirement Association in U.S. House of Representatives: Committee on Financial Services *Hearing Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises: Approaches to Improving Credit Rating Agency Regulation* (GPO 2009) 22.

‘nonissue’[9]. In assessing this range of opinion the Chapter will help us to understand one important point: in focusing on the effect of ancillary service provision upon the relationship between the agency and the issuer, the larger understanding of the impact of the agency upon the economy, and therefore society, is unfortunately missed. By joining the criticisms of the ancillary service provision with the economic theory of ‘economic rent’ and the concept of there being a divergence between the *actual* and the *desired*, the resulting analysis has the capacity to induce a wider understanding of the real effect of ancillary service provision upon the role of the rating agencies, which will be very important indeed.

5.2 S&P Capital IQ and Moody’s Analytics: Vehicles of Profit

The story of the rating agencies’ provision of ancillary services can be directly related to the growth experienced by the securities markets, and particularly the growth of asset-backed securities. We shall see that the agencies consciously built (and acquired) an arsenal of analytical tools that would see them become the central hub for parties who were partaking in the securitisation process, because not only were the structured finance ratings of the agencies

[9] Nicole Neuman asserts that ‘unlike the auditing industry, the credit rating industry does not need formal governmental regulation to solve the problems it faces… credit rating agencies have actually maintained their independence. The client-pays model does not tempt credit rating agencies to inflate ratings… furthermore, ancillary services are a nonissue because they contribute an insignificant fraction of the credit rating agencies’ total revenue. Finally, credit rating agencies have firewalls and self-regulations in place to prevent any conflicts of interests from negatively impacting the integrity of their rating processes’. The SEC, in utilising Neuman’s research as a counterbalance to criticisms of ancillary service provision, explain that for these conclusions the author ‘relies upon the (SEC) 2003 Report’. There are some very important issues here: firstly, Neuman’s is the only research to downplay the effects of the issuer-pays system and the provision of ancillary services, which then serves to single out the research; secondly, Neuman does not refer to the 2003 report when making these statements in the article, which suggests that it was not based upon the report at all. Even if Neuman used the 2003 report, to make such statements based on data that is over 7 years old is extremely misleading. We know from our own analysis that the issuer-pays system *does* result in ratings inflation, and that when the article was published ancillary service revenue for Moody’s accounted for *a quarter* of their entire revenue. For Neuman’s article see Nicole B Neuman ‘A Sarbanes-Oxley for Credit Rating Agencies? A Comparison of the Roles Auditors’ and Credit Rating Agencies’ Conflicts of Interests Played in Recent Financial Crises’ [2010] 12 University of Pennsylvania Journal of Business Law. For the SEC Report that cites Neuman’s work see Securities and Exchange Commission *Report to Congress: Credit Rating Agency Independence Study* (2013) 45.

required to decipher information that was not readily publically available (unlike corporate bond issuances), the acquisition of companies that already existed to support parties in the securitisation process irrevocably entwined the agencies to parties within the process.

The growth of the asset-backed securities market reveals to us the concerted and deliberate nature of the agencies' decisions. The Securities Industry and Financial Markets Association (SIFMA) has published figures that detail the growth of the sector in the US and the results make for a very interesting read when one considers the actions of the agencies, as we shall do in this chapter. In 1985 when the SIFMA's analysis begins, the total issuance of ABS, which for their analysis includes Automobile, Credit Cards, Equipment, Housing-related, Student Loans and Other securities, was just $1.2 billion. When Student Loans securities were first registered in 1993 the total issuance stood at $51 billion. Most interestingly for our analysis, when 'Housing-related' securities were first registered in 2003, the total issuance stood at $228 billion, with the housing-related securities making up just $55 million of that total. The next year that contribution rose to $270 million of $222 billion which demonstrates the relative explosion of the RMBS market that is so crucial to our analysis. Between 2003 and 2007 when the Financial Crisis took hold the issuance of housing-related securities had surpassed $900 million, with the total ABS issuance for the same period coming in at just under $1 trillion. Whilst the housing-related securities segment made up just 9 or 10% of the total ABS issuance, the rapid growth of that particular market had an effect on other markets too, with the general increase in fervour in the marketplace producing significant increases within the markets for automobile and student loan securities also[10].

These figures from SIFMA serve to demonstrate the rapid growth of the RMBS market that came to dominate the headlines surrounding the Financial Crisis. The figures will provide us

[10] The Securities Industry and Financial Markets Authority *Statistics: US ABS Issuance and Outstanding (1985 to 2016)* (SIFMA 2016).

with a statistical basis that will be required as a foundation for the following analyses concerning the evolution of the rating agencies' ancillary service offerings. It is worth noting before we continue that the aim of the agencies' creation of these divisions was not to just capitalise upon a market that would last for 4 years, but was also to cement itself within the securitisation process, because as we know from earlier the housing-related market went on to develop at an unprecedented pace just a year or two after the height of the Crisis[11] (a fact which is confirmed by SIFMA when it shows that housing-related ABS issuances rose to $2.6 billion after a two-year hiatus during the Crisis[12]). The agencies' cementation of their position in advance of such an incredible rate of growth in this particular market, not including the other sectors within which the agencies have a role to play once the securities have been bundled together, is the focus of the following analysis.

5.2.1 S&P Capital IQ

As was stated earlier in the introduction to this Chapter, any analysis of S&P's ancillary service division, S&P Capital IQ, will be naturally limited because of the private structure of S&P's parent company McGraw-Hill. Whilst the company do reveal the performance figures for its ancillary division on occasion, it is not consistent (and in some instances simply not available), which makes building a complete picture almost impossible without the assistance of McGraw-Hill directly. The most detail that is available on S&P and its divisions is contained within McGraw-Hill's yearly financial reports (Form 10-K) to the SEC. Whilst McGraw-Hill conceal the performance figures of S&P and its divisions before 2011 (the figures are all combined in 'segments' rather than individual companies and divisions), we

[11] See 2.3.1.1.2.2 *The SEC's 'Cease and Desist' Order against S&P* (n 99).
[12] The Securities Industry and Financial Markets Authority (n 10).

can see the acquisitions that took place and chart them against the evolution of the structured finance market *and* the financial performance of Moody's during the same period because, even though S&P is a larger agency, the presence of the duopoly dictates that the performance between the two has always been comparable.

In the next subsection we shall see that within Moody's Corporation lies two entities: Moody's Investors Services and Moody's Analytics, with the result being that one can easily chart the financial performance of the ancillary service division and then compare that to the performance of the Investors service which is Moody's traditional base. However, the 2016 Form 10-K of McGraw-Hill reveals the issue with assessing the divisions within S&P. McGraw-Hill differentiates itself into two divisions: McGraw-Hill Financial and McGraw-Hill Education. Within McGraw-Hill Financial there are a number of businesses including: S&P Ratings Services; S&P Capital IQ, which is adjoined to SNL which was acquired in 2015; S&P Dow Jones Indices; Platts; and J.D. Power. Platts, a company that provides information on price assessments for energy, petrochemicals, metals and agriculture markets is joined together by McGraw-Hill with J.D. Power, a company that provides marketing research, under the banner of 'Commodities and Commercial' (often abbreviated to 'C&C').

The issue with assessing the impact of S&P Capital IQ upon the rating agency is that S&P Capital IQ's figures have only been reported in isolation by McGraw-Hill from 2011 to 2013. Although we will look at the acquisitions made by McGraw-Hill in much more detail shortly, it is worth noting here that McGraw-Hill acquired Capital IQ in 2004, but it was not until 2010 that the company was merged with S&P to become S&P Capital IQ, and it would be another year until the company moved from being a standalone subsidiary to a McGraw-Hill financial company (with it being safe to assume that this was in response to the enactment of The Dodd-Frank Act). So, before 2011 the financial performance of the ancillary divisions of S&P are simply not reported by McGraw-Hill, which is in addition to the lack of information on S&P itself; McGraw-Hill provides financial information for the ‘financial services’ segment which includes S&P Dow Jones Indices as well as S&P Ratings Services, which is a very important market actor in its own right.

It is important to be as clear as possible when discussing these financial statements, as the complexity regarding the terminologies that are adopted have the potential to cause confusion and misinformation. Simply put, McGraw-Hill, before the end of 2011, only reported the results of the company overall together with what it called its ‘segments’: Education; Financial Services; and finally Information and Media. Even though the performance data for Standard & Poor’s for the 3 years prior to the 2011 financial statement was included in the 2011 submission, the point still stands that until that year the financial position of the rating agency was not definitively clear. What exactly happened in 2011 to initiate such a change in reporting standards is difficult to prove. What can be proven is that the firm underwent a significant phase of restructuring at that time as it went about selling a substantial portion of its Education arm, with the claim being that the firm wanted to move further towards Financial Services because of the reduction in opportunities in Education owing to the digitalisation of textbooks, amongst other things[13]. This is indeed plausible, although the incredible backlash against the lack of transparency demonstrated before the crisis may have been the most pressing reason for increased disclosure in this area.

This chapter’s aim was to introduce the ancillary service divisions adopted by the Big Two in much more detail, and in doing so demonstrate the effect that they had upon the business of providing credit ratings in such a unique situation as the pre-Crisis environment surely was. The hypothesis is that the agencies consciously developed such non-essential strands to their business in preparation for taking advantage of the hubris of the securitisation era, and also in taking advantage of their central position in the modern economy. We shall see shortly that

[13] Richard Summerfield ‘McGraw-Hill sells education unit’ [2013] Financier Worldwide.

Moody's Analytics was developed to flourish in the years prior to 2007/8, and that as a result of the position of the agency Moody's Analytics rose initially with the upsurge in securitised issuances in 2004, but crucially kept rising when securitised issuances crashed in 2007 and has continued unabated ever since; this would confirm the hypothesis that the agencies created the divisions to exploit the hubris of the pre-Crisis era *knowing* that the centralised position of the agencies would enable the divisions to become irremovable once the inevitable crash took place. It is regrettable that the figures for S&P Capital IQ are not available for the 15 years or so required to further confirm such a hypothesis; all that is available is the aftermath which confirms that, as of 2013 when McGraw-Hill last made S&P Capital IQ's performance data available in isolation, the division was recording revenues consistently in excess of $1 billion annually[14].

So, whilst we may not be able to demonstrate the financial impact that the provision of ancillary services had upon Standard & Poor's as it navigated its way through the extraordinarily lucrative pre-Crisis era, we can see how a number of acquisitions present the picture of a company preparing to take full advantage of its position. S&P's relationship with ancillary services began in the wreckage of the Enron affair when they acquired the consultancy arm of PriceWaterhouseCoopers, who had been essentially forced by the Sarbanes-Oxley Act to divest from the consultancy business after its appalling conduct, like many of the other top Public Accounting Firms. Interestingly, but admittedly a victim of hindsight, Ellen Haley who in 2003 was the Vice President of Development and Research at McGraw-Hill states in the Form 10-K submission that 'It's been said that the genius of capitalism is to pacify greed into benign self-interest. In the boom years, greed often went unchecked. Too many took advantage of a financial system that is based on trust and

[14] McGraw-Hill Financial, Inc. *Form 10-K* (SEC 2014) 81.

integrity. But now we're seeing changes…'[15]. Unfortunately for society, rather than the change being that 'auditors are now doing a better job' as Haley went on to suggest, the actual change was that the rating industry was evolving a practice that decimated the accounting industry and the marketplace.

The pressure created by the Sarbanes-Oxley Act had resulted in a mass-selling of highly focussed advisory services[16]. The timing of S&P's purchase of the consulting arm of PwC in 2001 could not have been better because in 2003/4 two important aspects emerged. Firstly, structured finance issuances began what turned out to be an unprecedented rise (as demonstrated by SIFMA earlier and Moody's' financial disclosures that will be assessed next) and secondly, on April 28th 2003, ten large investment banks settled with the SEC (and others) regarding conflicts of interest relating to equity research, with one important component of the settlement being that the firms spend $432.5 million over a five-year period to provide a minimum of three sources of independent equity research to their clients; Standard & Poor's almost jubilantly stated in their 2003 annual report: 'as a leading provider of independent equity research, Standard & Poor's believes that it is uniquely positioned to capitalise on this opportunity'[17]. This turn of events also allowed the agency to peddle their newly-acquired ancillary services to the investment banks that, through their own fraudulent behaviour, were now being funnelled through the credit-rating machine.

Building on this fortuitous turn of events, the agency then began a rapid phase of growth in relation to the securitisation process that was growing at an unprecedented rate. The lack of publicly available information in the process meant that the rating industry was central to both issuers and investors, and S&P made sure that they would have the tools to facilitate the

[15] McGraw-Hill Education, Inc. *Form 10-K* (SEC 2003).
[16] Kathryn Cearns 'Auditors and International Financial Reporting' in Carien van Mourik and Peter Walton *The Routledge Companion to Accounting, Reporting and Regulation* (Routledge 2013) 386.
[17] McGraw-Hill Education, Inc. (n 15).

business of its most important clients, the issuers. In 2004 when the rate of securitised issuances rose significantly, S&P purchased Capital IQ, a firm that specialised in offering 'high-impact information solutions to the global investment and financial services communities'[18]. S&P boasted that the newly acquired company allowed S&P to 'empower clients with workflow solutions and idea-generation tools', which was important because there was a noted increase in the issuance of U.S. CDOs which S&P stated were due to 'an improving economy, strong consumer spending, increasing investor confidence and the *quality of the underlying transaction collateral in CDOs*'.

We now know that this was not true at all. However, the aftermath of the Crisis has revealed the urgency in which the rating agencies sought to provide its clients with the ratings that were necessary to keep the process going; we saw earlier how the agencies adopted the Gaussian Copula formula in order to facilitate the ever-increasing amount of structured products that were being peddled. To compliment this approach the agency began adding a number of elements that would assist with this aim and encourage supplemental business through the ancillary division, so in 2005 the company acquired Vista Research, Inc. and CRISIL Limited, which increased the agency's capacity to deliver equity research on a global scale. They also introduced what is referred to as 'S&P Compustat', which was an improved database of financial, statistical and market data[19]. Superficially, these moves all paint a picture of efficiency which would have contributed to a greater understanding of risk within the marketplace, which in essence is the fundamental concern of a rating agency. But, through all of our analysis that has been conducted so far we know that this was not the case. S&P did not have a good understanding of the underlying collateral in CDOs and other securitised products, and they certainly did not seek to pass on this increased knowledge to investors who were devastated by the unprecedented amount of mass-downgrades in 2008.

[18] McGraw-Hill Education, Inc. *Form 10-K* (SEC 2005).
[19] McGraw-Hill Education, Inc. *Form 10-K* (SEC 2006).

What can be seen then is not a company that is seeking to provide for its clients and end-users but a company that is purposefully positioning itself within the financial information market *based upon* its ‘reputation’ garnered through its rating business, which is also a highly contestable notion in itself, in order to extract the maximum amount of money from the system.

S&P would go onto acquire a number of other companies to consolidate its position that it had created for itself[20]. What is clear to see when assessing the company and its decisions is that the Financial Crisis did not represent the end of any strategy but alternatively was only the beginning. The foresightedness is evident when we consider that in adjoining the research elements with the rating brand, at a time when all securitised products *had to be rated by an NRSRO*, the agencies had developed a consulting arm that would dwarf that of the accounting industry some years before. Furthermore, it was a business that would be developed in a way that those in power would consider the provision of ancillary services to be beneficial to the marketplace even when provided by such an integral sector of the financial system. In essence, Standard & Poor’s created, in just 7 years, a division that would record annual revenues that was almost the equivalent of the unprecedented record fine given to it by the US Justice Department; the effect of that punishment is therefore negligible at best.

5.2.2 Moody’s Analytics

Whilst assessing S&P Capital IQ’s performance and effect upon the fortunes of the rating agency was difficult given the nature of McGraw-Hill’s disclosure practices, we will have no such issue with the assessment of Moody’s ancillary service division Moody’s Analytics.

[20] Assirt; TheMarket.com; and Pipal Research Corporation have all been added to the ancillary service division since 2005.

Moody's Corporation, a public company, includes within its annual statements detailed performance information. As a result this section will examine the many acquisitions undertaken by Moody's, but crucially we can then attach this examination to an assessment of the financial performance of Moody's Analytics. What is revealed is that during the same upsurge in securitised issuances around 2004, as was detailed in the previous section, Moody's began an incredibly concerted operation to build an ancillary service division that would take advantage of the environment and the parent company's place within it. The result of this concerted effort was that today Moody's Analytics generates only a few hundred million dollars less than the revenue received from the rating of corporate bonds, which has always been the cornerstone of Moody's operations since the company was founded. This incredible fact lends credence to the contention of this thesis that the ancillary service division, and the issues that ensue, must be addressed because its impact is highly significant upon the fortunes of the rating agency.

Unlike S&P which had started in the ancillary field by acquiring the consulting division of PwC, Moody's took a different path. Initially, while S&P was profiting from the Sarbanes-Oxley rules, Moody's was being transformed into public company by Warren Buffett in 2000 as was discussed earlier; this may be a good reason why the company did not partake in the purchasing of accountancy-related consulting divisions in the wake of the Enron scandal. However, it did enter the ancillary marketplace with the acquisition of KMV in 2002, which was already a leader in the provision of qualitative credit analysis for lenders, investors, and corporations[21]. This acquisition was to be the cornerstone of Moody's Ancillary operations, and would be the brand with which Moody's ancillary services would be recognised until the

[21] Moody's Analytics *History of KMV* (2016). This was not the first acquisition by Moody's in this field, but it was certainly the first significant acquisition. The first acquisition was that of the Crowe Chizek Products Group.

adoption of Moody's Analytics in 2007 (the division was known as Moody's KMV prior to Moody's Analytics).

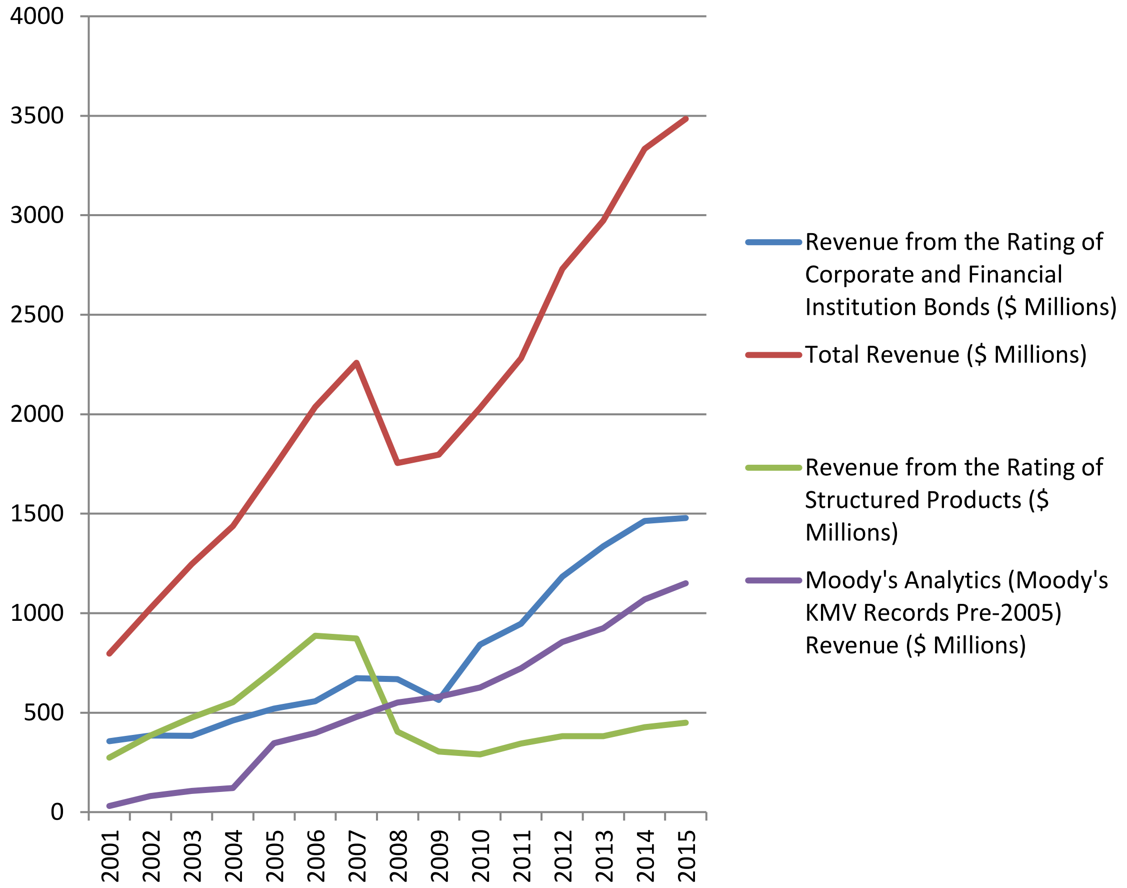
The significance of these acquisitions is only realised when one considers the environment before the Crisis in 2007/08. The rapid growth of the structured-finance market, which as discussed earlier was based upon (predominantly) non-public information, led to a duality which the rating agencies capitalised upon. After the acquisition of KMV, Moody's acquired Economy.com in 2005 and Wall St. Analytics in 2006; these companies would all be merged into Moody's Analytics in 2007. To explain this point regarding duality it is important to note the actual services being offered by these companies, which will then demonstrate why Moody's was acquiring them. KMV was the pioneer in creating commercially available credit loss predicting models, like the 'Loss Given Default' (LGD) model and the 'Expected Default Frequency' (EDF) model. Once connected to Moody's, KMV created the Moody's KMV RiskCalc and LossCalc models which became significant tools for banks and other market actors when trading in the structured finance markets. So, rating agencies made these models available to issuers and investors, in addition to the role in which any structured product had to have been rated by a leading NRSRO in order to be considered worthy of investment in the capital markets.

This incredible consideration, that the agencies' were effectively creating an additional business for something they were already doing but just packaging it to be used before the rating phase, is further demonstrated by understanding the purpose of Wall St. Analytics. In hindsight the acquisition of Wall St. Analytics in 2006 represents a clear conflict of interest when we consider that Wall St. Analytics was 'a leading provider of specialised software and data tools for the structuring, analysis, management, and servicing of structured debt instruments'. Furthermore, 'the addition of Wall St. Analytics enhanced Moody's Analytics' current Collateralised Debt Obligations product suite and immediately added mortgage-backed securities and asset-backed securities analytic software capabilities'[22]. It is clear from this description that Moody's sought to provide the consultancy for the preparation and maintenance of structured products that it would most likely have to rate (given that The Big Two were the overwhelming choice) in order for the products to enter the capital markets.

So, Moody's had positioned itself so that it was the gatekeeper to the capital markets (with the assistance of the SEC), so that it provided the information needed to efficiently structure and service structured products, and so that it provided the information regarding the risk involved with the process; with this all-inclusive approach being tied to the mercenary nature, as demonstrated throughout this thesis, it is little wonder that the financial system was on the verge of collapsing on the backs of these agencies. Moody's would go onto acquire six more companies in this quest to cover all the bases regarding the securitisation process[23] and a cursory analysis of the financial rewards for doing so reveal that, for the agency, it was very much worth it.

[22] Moody's Analytics *History of Wall Street Analytics* (2016).
[23] After creating Moody's Analytics as a 'separate' entity it would acquire Fermat and ENB consulting in 2008; CSI Global Education, Inc. in 2010; Copal Partners and Barrie & Hibbert Limited in 2011; and finally Lewtan and WebEquity Solutions in 2014.

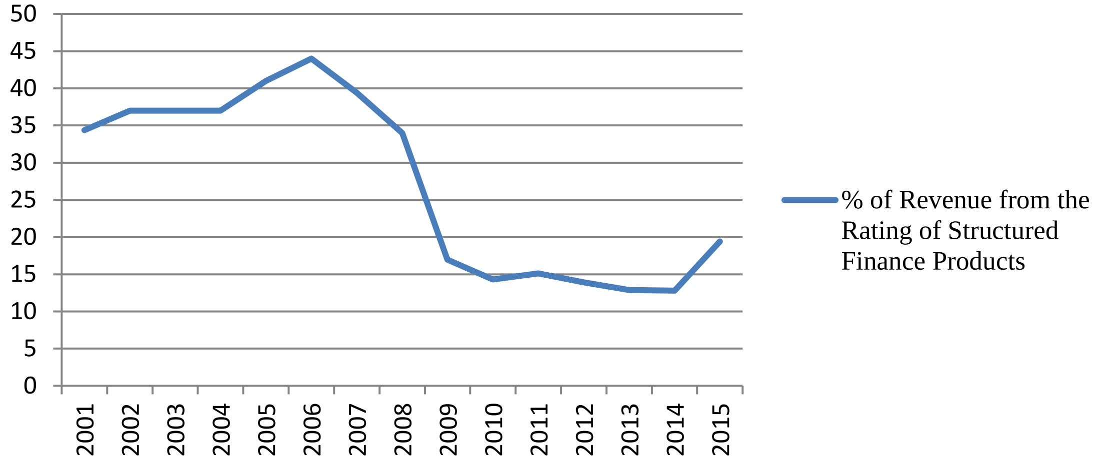
Table 1 - Collected Financial Data from Moody's Corporation Annual Statements 2001-2015



A simple collation of the figures declared in Moody's annual statements reveals the actual impact of the adoption of ancillary services at the turn of the century. Table 1 shows us that in just 15 years the Corporation has gone from recording revenues of $796 million in 2001 to $3.4 billion in 2015, which is an incredible achievement given the turbulent events of that short space of time. For our analysis of the ancillary services that the agency began to provide from 2002 onwards, we can clearly see that the revenues from ancillary services experienced a sharp rise in line with the sharp rise in structured product issuance around 2004, but more importantly kept rising even when structured and corporate finance issuances fell sharply during the Crisis in 2007 and 2008. In fact, there was a point in 2009 when ancillary services were generating more revenue for the corporation than any other revenue stream, which is extraordinary in itself. In 2013/14 the revenue from the ancillary service division surpassed the $1 billion mark for the first time, confirming its increasing importance to the health of the company.

These aspects of the financial figures are clear. What is also clear is that the data presented above would seem to confirm the hypothesis, established earlier, that the agencies (it is safe to assume that S&P Capital IQ has a similar trajectory) established these divisions in the knowledge that the position of the industry within the financial sector would mean that when the structured product boom (inevitably) collapsed, the division that was created to assist the boom would continue on. The real question is why would it continue on when the market for structured finance issuances collapsed and has yet to recover to pre-Crisis rates? The data above suggests that the market for corporate bond issuances recovered after one or two years, and we know from our earlier assessments that there is less need for the services that the ancillary service divisions offer, i.e. structured product risk indicators and assessments of non-public information, when one is concerned with corporate bonds; this is therefore hard to explain.

Table 2 - Collected Data from Moody's Corporation Annual Statements - % of Revenue from the Rating of Structured Finance Products



One explanation is that the agencies focussed more on the analytical side of corporate bond finance to fall in line with the dramatic drop in structured finance product issuance. However, we have already seen that this is not necessarily the case, because the agencies have continued acquiring components that enhance the structured-finance packages that they offer. Put simply, there is very little that the agencies can offer prospective clients when it comes to corporate bond issuances; the reason why the ancillary service divisions flourished with the expansion of the structured finance market and not before is because there is no real need for in-depth assessments of corporate bonds, owing to the publicly-available nature of the underlying information and the data that is contained within the ratings provided by the rating agencies (in addition to the specialised in-house analytical capabilities of sophisticated investors).

Table 2 reveals that the structured finance market did indeed drop significantly between 2006 and 2008 and has yet to recover. The fact that the ancillary service division of Moody’s has gone from strength to strength despite this obvious issue regarding its necessity leads to a very important inference. It is important for the development of this aspect of the discipline that we understand exactly what it is that clients find beneficial when subscribing to these services; more will be said on this point in the concluding chapter, because whether through qualitative or quantitative research there is a need to understand further the rationale of the division's clientele. The real reason why this is an important endeavour is because without any data regarding the benefits of usage of the ancillary services the only inference that can be made is that clients purchase the services to gain favour or protect their position, which is a conflict which is particularly venomous.

We shall see in the next section that many onlookers have realised this facet that is hard to explain and have come to the same inference as established above. In assessing these analyses it will be important to adjoin them to the bigger picture of the ancillary services contributing to the protection of the agencies against the only punishment that is deemed appropriate. The data above reveals that in just 15 years the agencies have managed to record annual revenues from ancillary services that in 2015 alone would have been enough to cover the record financial punishment given to Standard & Poor's by the US Justice Department; the incredibly high profit margins mean that the creation of the ancillary services has completely nullified the threat of the authorities and protected the agencies' bottom line which is the profits from its rating services – the modern agencies have finally developed an approach that more-or-less guarantees their survival, which since their inception in 1841 has been a constant issue owing to the nature of the business (i.e. deformation and economic loss liabilities, in addition to having their demand being dictated by economic fluctuations).

5.3 The Inherent Issues with Ancillary Service Provision – The View from the Literature

Though the practice of providing ancillary services continues unabated, there is a wide acceptance of the conflicts that come with the provision within the literature. In this section we shall assess some of the more obvious conflicts that are discussed within the literature before looking closely at the concept of 'economic rent'; this will be important because although the concept is a general economic concept that may or may not apply to each individual industry, we shall see that the general principle of a company extracting more resources than its input dictates is very much attributable to the ratings industry. The appalling performance of the industry over the past 15 years (and arguably longer still) simply does not tally with the incredible rate of growth and profitability we witnessed earlier with the declarations from the annual statements – the growth of a billion-dollar sub-division like Moody's Analytics (and S&P Capital IQ), based upon the unique position of the ratings industry, is a classic example of economic rent. This section will ultimately show that whilst the issues surrounding ancillary service provision are known, the bigger picture regarding the industry and its position within society is overlooked; the aim is to show that the ancillary services are not just an attempt to garner some extra revenue, but in fact represent a conscious decision to both embed the agencies further into the modern economy and protect against financial penalties that aim to stifle the fraudulent and criminal actions that have made the agencies multi-billion dollar institutions – removing this capacity has the potential to avert or lessen the impact of the next financial crisis given the centrality of the capital markets.

5.3.1 The Issue of Pressure

The most obvious conflict that comes with ancillary service provision is based upon the notion of ‘pressure’. With respect to the rating industry this can take one of two forms: either the agency exerts pressure upon its rating clients to purchase additional services, with the lure of potentially receiving or maintaining a higher rating; or alternatively the rating client could threaten to stop purchasing the additional services (which we know are incredibly lucrative for the agencies) unless a high, or at least required rating is given. We shall begin by assessing the first of these two forms which is referred to as ‘tying’.

‘Tying’ is simply when an agency would ‘force’ a rated company to purchase other services[24], although there are other examples of agency-dictated pressure that also represent the manifestation of conflicts. For example, it has been noted that agencies have requested payment for unsolicited ratings[25], have issued lower-than-warranted ratings to punish a firm for purchasing rating services from a competitor[26], and have also reduced or refused to rate a pool of assets (in a CDO for example) unless a substantial proportion of the pool’s individual securities were also rated by the same agency[27], which is a process referred to as ‘notching’.

The common word within the literature with regards to ‘tying’ is the word ‘fear’, as Rousseau states: ‘issuers may feel the need to subscribe to such services simply “out of fear that their failure to do so could adversely impact their credit rating (or, conversely, with the expectation

[24] Herwig P Langohr and Patricia T Langohr *The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They are Relevant* (John Wiley & Sons 2010) 423.
[25] Mark J Flannery ‘Supervising Bank Safety and Soundness: Some Open Issues’ [2007] 92 Economic Review 1 & 2 88.
[26] See 2.3.1.1.2.1 *Rhinebridge (and Cheyne Finance) SIVs* (n 93) for information on the case of Hannover Re where Moody’s downgraded the company in an unsolicited rating because the firm had chosen a competitor.
[27] Flannery (n 25).

that purchasing these services could help their credit ratings)'''[28]. The SEC and other authorities were aware of this practice and sought to prohibit it in the CRA Reform Act of 2006[29] after hearing testimonies from witnesses confirming their suffering at the hands of the agencies[30]. We shall cover the regulatory response to these conflicts in greater detail in 6.2 *The Imperfections in the Current Framework Governing Ancillary Service Provision*, but for now it is enough to state the SEC's position on such offences:

> Rule 17g-6 prohibits, among other things, an NRSRO from: (1) conditioning or threatening to condition the issuance of a credit rating on the purchase by an obligor or issuer, or an affiliate of the obligor, of any other services or products, including pre-credit rating assessments products, of the NRSRO or any person associated with the NRSRO; (2) issuing, or offering or threatening to issue, a credit rating that is not determined in accordance with the NRSRO's established procedures and methodologies for determining credit ratings, based on whether the rated person, or an affiliate of the rate person, purchases or will purchase the credit rating or any other service or product of the NRSRO…[31].

How one can 'prohibit' such behaviour when any pressure is usually implied is puzzling to say the least. In the case of the reinsurance firm Hannover Re, Moody's could not be held accountable because it defended its right to issue a rating that was not consistent with other rating agencies; in essence the clear lack of appetite to prosecute agencies for the breach of

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[28] Stéphane Rousseau 'Enhancing the Accountability of Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach' [2005] 51 McGill Law Journal 629; see also Deniz Coskun 'Supervision of Credit Rating Agencies: The Role of Credit Rating Agencies in Finance Decisions' [2009] 5 Journal of International Banking Law & Regulation 258; Lynn Bai 'On Regulating Conflicts of Interest in the Credit Rating Industry' [2010] 13 New York University Journal of Legislation and Public Policy 261 for the same sentiment.
[29] *The Credit Rating Agency Reform Act of 2006* Pub. L. 109-291, 120 Stat. 1327.; Jerry W Markham *A Financial History of the United States: From Enron-Era Scandals to the Great Recession* (Routledge 2015) 725.
[30] Committee on Financial Services *Credit Rating Duopoly Relief Act of 2006: Report 109-546* (GPO 2006) 13.
[31] Securities and Exchange Commission *Final Rule Analysis – Securities and Exchange Commission Release No. 34-72936; File No. S7-18-11* (2014) [n 70].

regulations means that these pressures, whether perceived or real, cannot be prohibited by regulation alone.

The second form that the conflict regarding the provision of ancillary services may take is when clients may put pressure on the rating agency to award a certain rating in response to continued business from the client. There have been a number of references to this aspect in the literature[32], with Macey and Bai both helpfully linking the issue of additional services in the rating industry to the issue of additional services within the Public Accounting industry which came to a head with the Enron scandal[33]. The lead-up to the Enron and WorldCom scandals provides a perfect example of the dangers of financial gatekeepers engaging with additional service provision and encouraged an abundance of scholarly work on the subject as a result[34]; for this reason, the stance taken in the aftermath by legislators, through the Sarbanes-Oxley Act predominantly, will be covered in much more detail in the next chapter because it serves as some form of inspiration for the proposal that will be advanced. It is worth noting before we continue that the same issue arises when looking at other industries' usage of additional services; the pressures exerted, either way, are rarely pronounced but subtly built into the relationships which makes regulating the additional services an almost impossible endeavour.

[32] Alcubilla and del Pozo (n 1) 145; Carol A Frost 'Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies' [2007] 22 Journal of Accounting, Auditing & Finance 480.
[33] Bai (n 28) 261; Jonathan R Macey 'The Politicisation of American Corporate Governance' [2006] 1 Virginia Law & Business Review 1 18.
[34] Just a few scholarly works that are representative of the vast amount of research conducted in this area regarding accounting firms' provision of additional services are Cearns (n 16); Mike Brewster *Unaccountable: How the Accounting Profession Forfeited a Public Trust* (John Wiley & Sons 2003); Dennis Caplan, Diane Janvrin, James Kurtenbach 'Internal Audit Outsourcing: An Analysis of Self-Regulation by the Accounting Profession' [2007] 19 Research in Accounting Regulation; Don E Garner, David L McKee, Yosra A McKee *Accounting and the Global Economy after Sarbanes-Oxley* (Routledge 2014).

5.3.2 Economic Rent Theory

Whilst there has been plenty of research concerning the immediate issues with rating agencies (and accounting firms before them) providing additional services, there is much less research which is concerned with placing the effects of that provision within a larger picture. It is undoubtedly true that there are a number of conflicts that arise from the provision of ancillary services, but this thesis aims to advance a proposal that sees the provision absolutely prohibited, so any discussion regarding the pressures within the working relationships that surround the rating industry are superficial at best when one is concerned with the dissolution of the service. It was noted earlier, and will be noted throughout the rest of the thesis, that the biggest issue with regards to the provision of ancillary services is that it has created an *excessive* revenue stream that is single-handedly protecting the agencies from feeling the effects of the only punishment that the authorities seem willing to prescribe i.e. financial penalties. We saw earlier how in just 15 years Moody's Analytics has breached the $1 billion mark in terms of revenue, which is absolutely extraordinary when the actual need for the service is unclear. It is this notion of excess that leads us into assessing the theory of 'economic rent', as Hirshleifer et al explain: 'Economists give the term *economic rent* a special meaning. It must be distinguished from the usual concept of rent as the hire-price for annual use of an acre of land, a building, or a machine. Instead, economic rent is defined as the *excess return* to any input'[35].

The theory of economic rent is arguably directly applicable to the ratings industry. However, it would be beneficial to examine the theory itself first before continuing because this notion of excessive return on the agencies' output is of real importance to the communication of this

[35] Jack Hirshleifer, Amihai Glazer, David Hirshleifer *Price Theory and Applications: Decisions, Markets, and Information* (CUP 2005) 402.

thesis. Congleton provides a very helpful analysis of the theory when he discusses the evolution of the theory itself. He begins by stating that the term 'rent seeking' was initially coined by Anne Krueger in 1974[36], in which she argued that the competition for the 'rents' associated with import and export monopolies caused a good deal of competition for positions within a given industry that consumed vital resources – talent, time, training etc. – which she ultimately saw as a *waste* of resources depending upon the value of the rent accrued i.e. the competition drove down the value of the rent[37]. However, unbeknownst to Krueger, Gordon Tullock had published a seminal paper almost a decade earlier which was also concerned with the quest for attaining unearned rents and the inefficiencies that came with that endeavour[38]. Congleton concludes that the early literature established the concept of 'rent-seeking' as 'the wasting of resources in the pursuit of "unearned" profits or wages, which were often obtained through public policies that were widely acknowledged by economists to be counterproductive'[39].

This rent-seeking behaviour, which is clearly attributable to the rating agencies' adoption of ancillary services in the build-up to the Financial Crisis, and the value that it seeks to achieve is dependent upon one aspect; Competition. Simply put, 'economic rent is smaller the greater the range of alternatives considered'[40], which is what Krueger and Tullock were referring to as being the most important factor in determining the value of the rent and therefore the efficiency of dedicating resources to its attainment. The common assertion in this regard is that industry participants would engage in concerted campaigns against policy makers to ensure that competition is kept to a level where the value of the rent outweighs the cost of

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36 Anne O Krueger 'The Political Economy of the Rent-Seeking Society' [1974] 64 The American Economic Review 3.
37 Roger D Congleton 'The Nature of Rent Seeking' in Roger D Congleton and Arye L Hillman *Companion to the Political Economy of Rent Seeking* (Edward Elgar Publishing 2015) 3.
38 Gordon Tullock 'The Welfare Costs of Tariffs, Monopolies, and Theft' [1967] 5 Western Economic Journal 3.
39 Congleton (n 37).
40 Hirshleifer (n 35) 404.

competing, and also of procuring the favour of the policy makers[41]. In thinking of the ratings industry it is clear to see that this aspect is inherently accounted for because, as we know already, the ratings industry is arguably a ‘natural oligopoly’ which means that the competitive costs in attaining rents are minimal (in addition to the assistance of the SEC with its NRSRO designation process in the mid-1970s).

This particular field is extremely well researched. However, when we apply the concept to the ratings industry and its adoption of ancillary services the outcome is particularly sinister. There have been a number of references to the output of the agencies constituting what is known as a ‘public good’, which is an economic term rather than one which denotes the moral nature of the ratings industry. The concept is based upon the notion that there are certain areas or aspects of society that need to be provided for the benefit of the public, and often there is little financial benefit to be garnered through doing so[42]. There are instances whereby the good needs to be produced, but the cost would be too high for the state to provide the good, so where possible the private sector would be enlisted to provide the good instead. Yet, with little financial benefit to be had from doing so the State will usually allow for the full or partial exclusion of access, which would lead to the creation of enough profit to make the provision of that good worthwhile for the private sector. In order to simplify this concept we can look at the example of the ratings industry and what is known as a ‘Public-Private Partnership’[43]. The growth of the capital markets, combined with the issues that stem from the State providing financial information for investors, means that the State is in no position to provide credit ratings for the marketplace. However, even though ratings are important to the functioning of the capital markets (when delivered accurately), the ‘free-riding’ that occurred in the late 1960s with the commercialised usage of photocopying

[41] Congleton (n 37) 4.
[42] Further details were discussed earlier, see 3.3.1.2 *The Impact of Technological Advancement*.
[43] Helmut Willke and Gerhard Willke *Political Governance of Capitalism: A Reassessment Beyond the Global Crisis* (Edward Elgar Publishing 2012) 8.

machines meant that the agencies could not 'capture' the financial benefit for providing the good. The answer to this conundrum is seen in the SEC's acceptance of the adoption of the issuer-pays model, which simultaneously allows for the 'public good' to be delivered whilst allowing for the agencies to capture the benefits of provision.

On the surface this seems to work well. However, the self-interested nature of the two parties, the issuers and the agencies, means that conflicts are inherent within that structure as we have seen throughout this thesis. Furthermore, whilst this situation may be bad enough, the agencies' adoption of ancillary services in the lead-up to the largest crash since the Great Depression constitutes what is known as a 'quid pro quo'[44], which means an advantage granted in return for something, which is also attributable to the concepts of economic rent and rent-seeking. It is entirely reasonable to suggest that the adoption of ancillary services in the rating industry, just two or three years after the largest accounting failure in history was directly related to the provision of additional services by accounting firms, is a prime example of a quid-pro-quo; the *excess* is an unspoken stipulation of the agencies' provision of a 'public good'.

Earlier it was said that assessing the role of the State and the agencies' adoption of ancillary services would result in a sinister evaluation. This is not because of the public-private-partnership theory that was advanced above, but because of an understanding advanced by Kofi Dompere, which is relatable to the rating industry situation, although it admittedly paints a particularly bleak picture when it comes to the possibility of advancing the public interest in this sphere. Dompere begins by positioning the issue of economic rent and rent-seeking as a process that requires 'the members of the principal (the State) to actively work to include in the social goal-objective set, the goals and objectives that create rent-seeking

[44] The theory can be traced back to Knut Wicksell and his work on the relationship between a government and its citizens, see Knut Wicksell *Finanztheoretische Untersuchungen nebst Darstellung ung Kritik des Steuerwesens Schwedens* (Jena 1896).

environments for social groups where specific rents may be exploited and harvested by specific groups. In this way, the members of the decision-making core (the agent) or the elected officials become nothing but economic puppets to non-politically elected salespersons'[45]. Although this is admittedly a very controversial take on the situation within society today, this should not reduce our willingness to evaluate it and incorporate it into our understanding of the ratings industry if it is indeed fitting.

Dompere continues:

> The game is played with the constitution as the umpire. The whole process involves: 1) the establishment of the social decision-making core (the elected officials or the members of the agent), 2) the selling and buying of influence in order to affect the direction of votes to create the social-objective set, national interests and social vision, that define a rent-seeking environment favourable to specific interest groups, and 3) the exploitation of the environment for private gains through non-wealth-creating transfers through resource allocation for output production and income-wealth production. Number one is called influence tampering; number two is called rent-creation; and number three is called rent protection and harvesting[46].

In using this template to evaluate the ratings industry situation it becomes difficult to disagree with Dompere; we have seen instances throughout this thesis of the 'revolving door' theory (influence tampering), concerted lobbying campaigns (rent-creation), and the establishment of revenue streams that are excessive (harvesting). Furthermore, we have seen how the Dodd-Frank Act, amongst a host of other legislative and regulatory moves have served to empower the agencies rather than discipline them. Dompere again encapsulates this phenomenon: 'The

[45] Kofi K Dompere *Fuzziness, Democracy, Control and Collective Decision-choice System: A Theory on Political Economy of Rent-Seeking and Profit-Harvesting* (Springer Science & Business Media 2014) 6.
[46] ibid.

political structure offers opportunity for *rent creation* and the *legal structure* offers opportunities to *protect rent*, while the *economic structure* with the four aggregate markets offers opportunities to *harvest rent*'[47].

Yes this version of events paints a dismal picture, but the evidence points towards it being the case. It is noted within the literature that the agencies are generating rental returns irrespective of their performance[48], that regulations are directly allowing rent-seeking activities to take place[49], and that the NRSRO designation in the mid-1970s was a clear indication of this process taking place[50]. The entirety of the second chapter of this thesis was dedicated to the principle of focusing on the *actual* rather than being led by the quest for having the *desired* realised and that principle is directly attributable here; the reality is particularly downbeat with regards to the potential for change, but to overlook the reality whilst attempting to make any sort of inroad is simply not the way to approach the task of initiating any form of change for the benefit of the public.

5.4 Conclusion

The aim of this chapter was to gain a better understanding of the ancillary services that the Big Two offer, whilst also assessing the issues that come with this provision. In addition to this, the chapter aimed to move the discussions regarding ancillary service provision in the literature forward by adjoining the concept of economic rent, primarily in order to

[47] ibid.
[48] Jonathan R Macey 'The Nature and Futility of "Regulation by Assimilation"' in Greg Urban *Corporations and Citizenship* (University of Pennsylvania Press 2014) 212.
[49] D T Llewellyn 'Banking in the 21st Century: The Transformation of an Industry' in Tom Valentine and Guy Ford *Readings in Financial Institution Management: Modern Techniques for a Global Industry* (Allen & Unwin 1999) 40.
[50] L J Rodriguez 'The Credit Rating Agencies: From Cartel Busters to Cartel Builders' in William A Niskanen *After Enron: Lessons for Public Policy* (Rowman & Littlefield 2007) 227.

demonstrate the claim here that the ancillary services are single-handedly nullifying the effects of financially-based punishments.

We began by assessing S&P's ancillary offering S&P Capital IQ. Gaining a precise understanding of its impact upon the rating agency was difficult because S&P's parent company, McGraw-Hill Financial, is not consistent with its terminologies or with its categorisations within its annual financial statements. Whilst gaining a complete picture of the financial performance was not possible, we saw that the aftermath of 15 years' worth of conscious and purposeful development was that the division now records annual revenues of over $1 billion consistently. This lack of information regarding S&P Capital IQ was somewhat offset by the nature of the ratings industry, because although S&P hold a slightly larger market-share than Moody's, their financial performance is generally comparable and has been for some time. Moody's ancillary service offering, Moody's Analytics provided us with a perfect opportunity to assess the incredible rates of growth within this particular business and subsequently the financial effect that growth has upon the rating agency. We saw through analysing Moody's' annual statements that the division's growth was not solely tied to the development of the structured finance market, which raises concerns as to the reason for its growth.

In this regard we assessed some of the claims within the literature to try to understand why the ancillary divisions would show *consistent* growth despite the collapse of the structured finance market, damning blows to the reputation of the agencies, and a lack of a definitive reason for the necessity of the services. A number of scholars intimated that the notion of 'pressure' is prevalent within the ratings industry, in that agencies may apply implied pressure upon clients to purchase additional services, or clients may apply implied pressure upon agencies to rate favourably in return for continued business. We saw that whilst regulations exist to prohibit such behaviour, the implied nature of this pressure means that one simply cannot regulate against it. Also, one may be forgiven for concluding that the purchasing of additional services may be as some sort of ‘reward’ or ‘tax’ for the agencies’ facilitation of what was in essence fraudulent securities trading in the lead-up to the crisis.

One issue that consistently arises when researching the credit rating industry is the issue of moving into controversial realms. The short suggestion above concerning ancillary service subscription as constituting a reward for facilitation may indeed be viewed as controversial or fanciful, but the nature of the ratings industry dictates such actions; the way in which conservative thought views the industry simply does not tally to the output of the agencies and the scandals that consistently emerge concerning their conduct. This was demonstrated at the end of the chapter when the work of Kofi Dompere was assessed in relation to the theory of economic rent and rent-seeking. Dompere’s account is extraordinarily divisive, yet when it is applied to the *actual* reality of the ratings industry it seems to fit very well. Dompere’s take accounts for the lack of appetite from the authorities to make impactful changes, whilst it also accounts for the self-interested and mercenary nature of the rating agencies themselves.

Ultimately there are larger points raised by this chapter which serve as the culmination of the analyses that have gone before it and a foundation for all that follows. The notion of there being a divergence between the *actual* and *desired* is clearly demonstrated when looking at the response to the agencies’ adoption of additional services. In the modern era, one that is centred upon the economy and the capital markets, the rating agencies are arguably as important as Public Accountants. Yet, whilst the accountancy industry was vilified for its use of additional services in the lead-up to the Enron scandal, the rating agencies have received comparatively very little coverage for its adoption of what, in essence, are the very same divisions. The impact of the Enron scandal upon society is simply not comparable to the Financial Crisis, yet the mounds of research concerning additional services is predominantly concerned with the accounting industry, even some 15 years after the fall of Enron.

This demonstration of the common view being to ignore or downplay the *actual* version of events has contributed to a stark reality. Firstly, as has been stated on a number of occasions, the provision of ancillary services has given the agencies an *excessive* revenue stream that directly nullifies the effects of 'record' and 'unprecedented' disciplinary measures like the $1.375 billion fine given to S&P in 2015. Secondly, and perhaps more importantly, the continued presence of this revenue stream not only protects the agencies from discipline, but it also provides the initiative to become involved in other structured-finance based scandals, because the authorities have demonstrated quite clearly that they are not prepared to discipline the agencies in any meaningful manner; recent developments within the structured-finance market for automobile sales in the US represent this very danger[51].

Ultimately the provision of ancillary services presents conflicts and outcomes that are not acceptable when assessed through the lens of trying to increase public protection. Whilst the issuer-pays model is justifiable in terms of allowing for the provision of a 'public good', the provision of additional services that do not have a bearing upon the accuracy of credit ratings is quite simply not acceptable when assessed through the same lens. It is for this reason that the next chapter endeavours to position and explain a reform proposal that would bring an immediate end to these conflicts and warped outputs, because the public is in real danger of being subjected to another rating industry-facilitated financial malfunction that would make mass-austerity measures and a general reduction in social wealth the norm rather than a once-in-a-generation event.

[51] Journalists point towards a raft of defaults within the Automobile finance market as potential evidence for lax underwriting standards in the face of high ratings, see Serena Ng 'Subprime Flashback: Early Defaults Are a Warning Sign for Auto Sales' [2016] Wall Street Journal (Mar. 13).

Chapter 6 – A Reform Proposal

6.1 Introduction

In the last chapter we sought to gain a more detailed understanding of the ancillary service divisions of Moody's and Standard & Poor's, an analysis which resulted in the clear demonstration of divisions that do not contribute to the accuracy of credit ratings yet contribute almost as much to the financial health of the agencies as the primary function of the credit rating agencies. We saw, in no uncertain terms, that the agencies had consciously taken advantage of their centralised position within the burgeoning structured-finance market to create divisions that served almost as a levy for their participation in a system that brought the world to a standstill in 2008. In addition to the views within the literature concerning ancillary service provision, that advance the notion that ancillary service provision creates pressures within the working relationships that govern the ratings field i.e., agencies threatening clients with lower ratings or clients threatening the withdrawal of their business in response to unfavourable ratings, the last chapter attached the economic study of 'rent' and 'rent-seeking' behaviour to the views within the literature to form a much deeper and impactful understanding; we ultimately saw that the provision of ancillary services represents the 'rent' or undue reward for the agencies that was incorporated in anticipation of the industry's involvement with the often-fraudulent securitisation process that came to define the 2000s.

This conscious development of a rent-harvesting division has had other effects however. The most dangerous effect of the incorporation and incredible success of the ancillary service divisions has been that the discipline selected by authorities has in effect been entirely nullified. We saw earlier in the thesis that the $1.375 billion fine given to S&P for its conduct during and after the Financial Crisis was heralded as an unprecedented victory for investors and the public, although in the last chapter we saw evidence from the financial statements of the Big Two that the ancillary service divisions have been recording revenues in excess of $1 billion for a number of years; this offsetting, based upon a division that could technically be removed and not impact upon the accuracy of ratings at all, is the core issue for this thesis.

So, in light of this understanding, this thesis will now draw to a close by establishing a reform proposal that has the potential to end that offsetting capability once and for all. The proposal, which in essence calls for the complete prohibition of any additional services that may be offered by the credit rating agencies, has been constructed so that *technically* it could be accepted and put into practice. However, while there are no technical impediments to the theorised adoption of this proposal, there are a number of impediments that must be addressed when we consider the *actual* world in which we live. Therefore, this chapter will endeavour to assess all of these issues and ultimately ascertain the potential for such impactful reforms succeeding in this field.

To begin with the chapter will assess the current regulations that govern the provision of ancillary services by the rating agencies. While this thesis' mandate of providing an *impactful* reform proposal obviously dictates that there is a belief that current measures are not appropriate, it will still be important to describe the current framework so that we can see where the flaws are; doing this will then lead to the understanding of what is required to initiate the publicly-concerned reforms that this thesis calls for. Also, we have the benefit of hindsight to assist our analysis, which will allow us to see that the agent who was given the power to discipline the agencies, the SEC, has taken an extraordinarily lenient approach to their task, which simply enhances the argument that only complete prohibition can work rather than a constrained version of the provision that would be regulated by the SEC.

Once the imperfections in the current framework have been established, the natural progression will be to then establish the proposed remedy to the issues that are inherent within the provision of additional services by socially-vital financial gatekeepers. However, with such a divisive proposal there is usually a desire to establish some element of precedent or ‘inspiration’, so the next section of the chapter will establish two separate instances whereby the additional services provided by socially-important financial gatekeepers have been prohibited for the apparent protection of the system, and therefore the public. However, there are issues with each instance that mean that to use the word ‘inspiration’ to describe them could be problematic, so it is perhaps better to understand them as historical benchmarks. We shall see that the forced separation in 1933 of ‘Universal’ banks, banks which housed both investment and commercial divisions, has been understood in hindsight to have been politically motivated, which many have used as an impetus for an attack upon the notion of public intervention. In 2002, the Sarbanes-Oxley Act initiated the forced divesture of the Chartered Public Accounting firms’ consultancy service divisions in response to the systemic conflicts that allowed for the colossal collapses of Enron and WorldCom, although the issue with this instance is that the prohibition was not indefinite and additional service provision has resumed in less than a decade.

Using these instances as a basis for advancing the proposal that the agencies’ provision of ancillary services should be completely and irreversibly prohibited, the chapter will then go on to establish and detail each component of the reform proposal. This section will be as clear as is possible in order to communicate the measures proposed, and their effects, as effectively as possible. Once the proposal has been established the chapter will then go through the hypothesised benefits to the proposal, if it were to be enacted, before discussing the potential impediments to it being accepted and incorporated. Whilst it is important to be positive when suggesting such socially-important changes to the system, the list of potential impediments is extensive and contains elements which would mean a societal shift is needed if any meaningful change is to be forthcoming. However, it is precisely moments like these where the commitment to assessing the *actual* becomes vital when it is all too easy to be dismayed and retreat to the relative comfort of focussing upon the *desired*; the *actual* must be addressed and communicated if we are to stand any chance of aligning the output of the rating industry with the pursuit of the public's protection.

6.2 The Imperfections in the Current Framework Governing Ancillary Service Provision

As we saw briefly in 1.4 *A Snapshot of the Regulatory Framework*, the rating industry was not directly regulated until 2005/06 with the Credit Rating Agency Duopoly Relief and Credit Rating Agency Reform Acts, with any regulatory intervention before then being to facilitate the industry's development rather than constraining its conduct. The aspects considered by the Acts in 2005/06 were built upon and expanded by the Dodd-Frank Act of 2010, in which the stated aim was to remove the binds that kept the economy tied to the agencies. However, there is very little to be said regarding the provision of additional services within these Acts, as the procedure is to delegate the actual setting of individual rules, on a technical basis if nothing else, to the SEC. The purpose of this is that this delegation is attached to the stipulation that the SEC must conduct extensive reports and then report back to Congress with its findings in a particular area. We can see this process within the SEC's *Final Rules*, documented in 2014, which serves as the most up-to-date record of the amendments made to the Securities Exchange Act of 1934 under the direction of the Dodd-Frank Act[1].

Within the SEC's *Final Rules* publication we can see the actual constraints that surround the agencies' provision of ancillary services. As was detailed earlier in Chapter 5 *The Issue of*

[1] Securities and Exchange Commission *Final Rule Analysis: Securities and Exchange Commission Release No. 34-72936; File No. S7-18-11* (2014) 23.

Ancillary Service Provision[2], the SEC confirms that Rules 17g-5 and 17g-6 of the Securities and Exchange Act of 1934 prohibit the agency from rating an issuer who they have had contact with before concerning the corporate or legal structure, assets, liabilities or activities of that issuer, and that the agency is prohibited from conditioning or threatening to condition the issuance of a credit rating on the purchasing of additional services i.e. tying.

The acceptance of the 'tying' process existing was developed in the CRA Reform Act of 2006[3] as a response to the many testimonies heard by Congressional committees concerning the 'abusive' industry practices like 'tying', issuing unsolicited ratings with a bill, and 'notching'[4]. So, Rule 17g-6 is an example of the SEC's response to the legislative body instructing it to develop countermeasures to the aspects it decides need to be addressed, which was an amendment initially established (tentatively) alongside the 17g-5 amendments in 2009[5].

In confirming the scarcity of reference to the provision of ancillary services, the only other Rule that is concerned with the provision is Rule 17g-7, which determines that if a credit rating is issued it must be accompanied by a disclosure form by the agency which details whether or not that issuing party has paid for any additional services (before the rating was paid for, as there are strict limits to what the issuer may purchase *after* the rating has been paid for). Initially the SEC had differentiated the need for disclosure between solicited and unsolicited ratings, although this was altered when a commenter on the proposed rules raised the concern that an NRSRO analyst may then have the opportunity to know whether a firm

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[2] 5.1 *Introduction* (n 6).
[3] Jerry W Markham *A Financial History of the United States: From Enron-Era to the Great Recession* (Routledge 2015) 725.
[4] Committee on Financial Services *Credit Rating Agency Duopoly Relief Act of 2006: Report 109-546* (GPO 2006) 13.
[5] Lynn Bai 'On Regulating Conflicts of Interest in the Credit Rating Industry' [2010] 13 New York University Journal of Legislation and Public Policy 278.

had purchased additional services from their rating firm[6]. Though this is logical in practice, there have been a number of confirmed instances whereby analysts have been directly involved with the marketing of ancillary services[7], which is an extraordinarily troubling issue and is representative of the *actualities* of the rating industry.

This concept of the SEC trusting in the agencies to separate the divisions within its business is very important, and allows us to begin to focus upon the inadequacies of the current framework. In Chapter 1 *A Primer on the Credit Rating Domain* it was explained that the ancillary service divisions, using Moody's Analytics as the example, serve as the sales and marketing arms of the rating agencies as well as the provider of additional services. With this understanding we can see that the SEC do attempt to regulate the ancillary service divisions further when they state that 'section 15E(h)(3)(A) of the Exchange Act provides that the Commission shall also issue rules to prevent the sales and marketing consideration of an NRSRO from influencing the production of ratings by the NRSRO'[8]. This 'absolute prohibition'[9] is clear and unwavering. Yet, we have already heard of testimonies of the 'Chinese Walls', or 'Information Barriers' as the SEC would prefer they be called[10], failing, with the SEC itself, whilst conducting its examinations of the agencies in the preparation of these final rules, finding that within the Big Three it appeared 'employees responsible for obtaining ratings business would notify other employees, including those responsible for criteria development, about business concerns they had related to the criteria'[11].

[6] Securities and Exchange Commission (n 1) 332.
[7] Bai (n 5) 261.
[8] Securities and Exchange Commission (n 1) 99.
[9] ibid 100.
[10] Securities and Exchange Commission *Self-Regulatory Organisations; International Securities Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendments No. 1 and 2 Thereto to Amend the Market Maker Information Barrier Requirements under ISE Rule 810: Release No. 34-50197; File No. SR-ISE-2004-18* (SEC 2004) 1.
[11] Securities and Exchange Commission (n 1) 100.

However, this was not an isolated finding. The SEC found in 2015 that 'one larger NRSRO and three smaller NRSROs did not have sufficient policies, procedures, and controls to manage the issuer-paid conflict or to prevent analytical personnel's access to fee or market-share information'. It also found that 'an analytical supervisor (who was not authorised to grant such an exemption) at this (larger) NRSRO suspended analyst rotation for several months for a substantial number of ratings in an asset-class without obtaining the required written exemption' and that a senior officer of the same NRSRO 'violated its policies and procedures by sending emails to analytical and criteria-development personnel concerning an issuer's decision to terminate its rating in response to revisions by this NRSRO to its criteria'[12]. The incredible violations of the law do not stop there; the SEC found instances of the agencies not reporting issuers who the agency suspected of committing material violations of the law, of issuing unsolicited ratings motivated by market-share considerations, and of directors who were declared as being independent but also served on the non-NRSRO parent companies or affiliates.

These incredible and brazen violations of the law confirm Richard Portes' view that 'Chinese Walls will not do'[13]. However, it surely raises the question of why they feel so comfortable in breaking the law. Fortunately for our analysis, but unfortunately for society, that is a question that has a simple answer. The answer lies in the following statement from the SEC, a statement which is repeated consistently within the report on the findings of systemic law breaking: 'The Staff recommended that this NRSRO enhance its internal controls to ensure that all personnel adhere to this policy'. This sentiment is repeated time and time again and simply confirms the weak and pro-business nature of the SEC; that material violations are treated in this manner is nothing short of outrageous. In the same report the SEC detail the

[12] Securities and Exchange Commission *2015 Summary Report of Commission Staff's Examinations of Each Nationally Recognised Statistical Rating Organisation* (SEC 2015) 15.
[13] Richard Portes 'Ratings Agency Reform' in Carmen Reinhart and Andrew Felton *The First Global Financial Crisis of the 21st Century* (VoxEU 2008) 149.

disciplinary measures it has at its disposal, which include relatively small fines, limitations on activities and short-term censuring prohibitions (the like of which we assessed with the cease-and-desist order given to S&P), and ultimately the revoking of an agency's NRSRO licence. However, why none of these measures were utilised in response to these blatant violations is unknown and in truth a damning demonstration of the SEC's inability to safeguard the public interest.

All in all is it very difficult to disagree with Eichengreen's assessment that 'the credit-rating agencies, legislative handwaving aside, were able to escape significant regulation and reform'[14]. The current regulatory framework that surrounds the agencies, on all levels, is incredibly weak. It is not illogical to presume that an effective post-crisis regulatory effort would result in a systemic lowering of profits within that particular sector being governed for some considerable period of time, but for the rating industry to have experienced just two or three years of contraction before resuming and surpassing record levels of revenues and profits is extraordinarily objectionable, and ultimately stands as the truest representation of the weakness of the regulatory framework governing the ratings industry.

It is contested here that this weakness is inherent within the SEC because of its constitution, although it must be stated that this contention could be applied to any number of agents of the State. There is an unnerving favouring of business over the public in the minds of agents which is demonstrated by their passive response to material violations of the law. When we add this understanding to the U.S. Department of Justice having to *negotiate* with criminally liable companies like the rating agencies in order to find a level of fine that was appropriate for the agencies, and then championing this process as a positive result for the public, the true nature of what lies in front of us is evident. It is in this light that the following proposal is

[14] Barry Eichengreen *Hall of Mirrors: The Great Depression, The Great Recession, and the Uses-and-Misuses of History* (OUP 2014) 386.

predicated upon the notion that what is needed is not a simple reform proposal but ultimately a drastic sea-change in mind-set, so that the public's protection is at the forefront of every agent of the State. The call for incremental and clearly-defined reform proposals that are based upon the understanding of the agencies as they *actually* are is valid, yet the impediments to those reforms being recognised are great, as we shall see later, and this is something that, although pessimistic, must not be forgotten.

6.3 Precedent for State Intervention

Simply put, this thesis serves as a vehicle to advance a sentiment that is solely concerned with protecting the public from the iniquities of the financial sector. For almost a decade we have witnessed extensive poverty and 'austerity' that is the sole result of the actions of a few. To present an overarching proposal to eliminate this inherent problem may be academically appealing but is in essence useless against such an engrained adversary. So, in what is a minute attempt to initiate incremental change that will allow for the credit rating industry, which as we know is the sole gatekeeper determining access to the capital markets, to be exposed to the possibility of experiencing discipline through financial penalties, the only discipline the State is willing to administer, this chapter will now present a reform proposal that calls for the absolute and irreversible prohibition of the provision of additional services by credit rating agencies.

This proposal is not complex. It is not complex because simplicity is the only way in which one can communicate the necessity of action in this regard, and also because the wrongdoing that is being committed is also extraordinarily simple; the agencies incorporated a business for harvesting rent, this thesis proposes that that business be removed. There are however a small number of elements that need to be addressed in order for the proposal to be established as *technically* credible, because even though the reality of the situation may dictate that it will be incredibly difficult to enact any impactful reform, establishing technically possible reform proposals at least provides us with an opportunity to assess the likelihood of implementation. Also, if a proposal is advanced in such a simple but studied manner, but is not considered, we then have the foundation to ask 'why'.

Before we take a closer look at this proposal it will be useful to examine some other instances where influential financial sectors have had their additional, conflict-creating side-businesses stripped from them in the name of public safety. Doing this will demonstrate two things: firstly it will show us that this issue is not unique to the rating industry, and is perhaps a systemic issue of exploitation *in spite* of the potential harm to the public; and secondly it will show us the potential failings of such moves so that we can incorporate the understanding of such failures into our proposal in order to potentially increase its possible effectiveness. Whilst the proposal advanced by this thesis is incredibly simple, the environment in which it would be enacted is anything but.

6.3.1 The Termination of Universal Banking – 1933

The financial collapse in 1929 that initiated one of the most destructive periods of economic contraction in modern history was unerringly similar to the financial collapse of 2007/08 in a number of ways[15]. Whilst the details were similar however, in that the explosion of the securitisation process expedited the effects of systemic greed, the response taken by the State

[15] See Owen F Humpage *Current Federal Reserve Policy Under the Lens of Economic History* (CUP 2015) for an analysis of the comparisons with regard to financial policies. For an analysis of the economic and sociological comparisons see Eichengreen (n 14).

was radically different, although how much of that depends upon the environment at that time is up for debate. In this section we shall see how the incredibly powerful and influential banking magnates were in a heated battle with the State to protect their position, but also how modern analysis has portrayed this epic battle as a confrontation that was based upon a fabrication. In assessing the actualities of the unprecedented actions taken during the 1930s, in addition to the modern analyses, we shall see how it is conceivable that State agencies utilised the public anger directed towards the banking industry to initiate incredibly extensive reforms, reforms which people argue instigated the 'Quiet Period' of 70 years of financial stability, or alternatively instigated a period of cartelisation within the banking industry that continues to this day.

The 'roaring twenties' is an era that came to define the unrestricted excesses of the free market within the United States. Defined by the extravagant riches that were available, the 1920s represented the period when securities became commonplace and were peddled to the public on a mass and organised scale. Charles E Mitchell, President of the National City Bank (the ancestor of today's CitiGroup) and its security-issuing affiliate The National City Company, was quoted as saying that the aim was to sell securities 'just as United Cigar Stores sold cigars'[16]. Crockett et al confirm this escalation in the offering of securities during this period: 'The number of banks operating a securities business in an internal bank department grew from 62 to 123 between 1922 and 1931. Even more rapid was the development of separate securities affiliates, which rose from 10 in 1922 to 114 in 1931'[17]. This combination of banks that served the general public in terms of accepting deposits, and

[16] Jerry W Markham *A Financial History of the United States: From Christopher Columbus to the Robber Barons 1492-1900* (M.E. Sharpe, Inc. 2002) 116.
[17] Andrew Crockett, Trevor Harris, Frederic S Mishkin and Eugene N White *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?* (Centre for Economic Research Policy 2003) 62.

of security-issuing affiliates or investment banking divisions, is what is referred to as 'Universal Banking'.

The reasons why Universal Banking was, and indeed still is desirable to some is straightforward. Essentially, the commercial bank can utilise the expertise of the focussed affiliate to analyse securities that the commercial bank itself would then purchase (or market to its large customer base). The capabilities of the commercial bank, owing to its increased size relative to a specialised investment bank, means that the bank would have a large number of potential clients who could also deposit the securities with the bank, effectively transforming it into a 'discount broker' of securities[18]. However, this increase in scope in turn increased the systemic susceptibility to risk-laden security issuances, which unbeknownst to the public was becoming a reality at that time because of the actions of a few manipulative individuals. Charles Mitchell was held up as the arch-villain in the subsequent congressional hearings that would take place because of the centrality of The National City Company to the flooding of the marketplace with poorly underwritten securities. However, legislators were already focussed upon the issue of risky and sometimes fraudulent securities because of the actions of the infamous Samuel Insull[19], the owner of Middle West Utilities, and perhaps the even more notorious Ivar Kreuger[20], the spearhead of monopolies that enveloped the western world in the 1920s, both of whom flooded the market with securities that were built upon excessive risk and, in a lot of cases, outright fraud.

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[18] ibid.
[19] For more on the Samuel Insull and his impact upon the development of securities regulations see Barrie A Wigmore *The Crash and Its Aftermath: A History of Securities Markets in the United States, 1929-1933* (Greenwood Publishing Group 1985); J E Ketz *Accounting Ethics: Crisis in Accounting Ethics* (Routledge 2006); Forrest McDonald *Insull: The Rise and Fall of a Billionaire Utility Tycoon* (Beard Books 2010); Robert L Bradley *Edison to Enron: Energy Markets and Political Strategies* (John Wiley & Sons 2011) 206-13.
[20] For more on the truly remarkable story of the rise and fall of Ivar Kreuger see Trevor Allen *Ivar Kreuger, Match King, Croesus and Crook* (John Long Ltd 1932); Allen Churchill *The Incredible Ivar Kreuger* (Rinehart & Company, Inc. 1957); Robert Shaplen *Kreuger: Genius and Swindler* (Alfred A Knopf 1960); Dale L Flesher and Tonya K Flesher 'Ivar Kreuger's Contribution to U.S. Financial Reporting' in J E Ketz *Accounting Ethics: Crisis in Accounting Ethics* (Routledge 2006); Frank Partnoy *The Match King: Ivar Kreuger and the Financial Scandal of the Century* (Profile Books 2010); Tage Alalehto 'Ivar Krueger: An International Swindler of Magnitude' [2014] 3 Radical Criminology.

The result of the incorporation and spreading of this increased systemic risk was an unprecedented crash and subsequent Depression. To attempt to resolve this unprecedented failure the State sought to undertake an unprecedented regulatory response. This response began with an investigation by the Senate Banking Currency Committee which would come to be known as the 'Pecora Hearings', named after the eventual figurehead of the investigation, Ferdinand Pecora[21]. The investigation unearthed a number of conflicts that the Committee blamed upon the connection between commercial and investment banking: bankers were blamed for selling "unsound and speculative securities" generated by their security-issuing affiliates; banks were converting bad loans into security issues that were sold to an unsuspecting public; and also that security affiliates were conducting pool operations with the stock of the parent bank, which was inducing a number of personal conflicts of interest[22].

The legislative response, which when taken as a series of responses was branded as the 'New Deal'[23], began with the enactment of the Securities Act of 1933 and the Banking Act of 1933, and included a range of other pieces of legislation enacted as part of 'programs' like 'Economic Stimulus and Stabilisation' and 'Relief and Welfare'. Sections 16, 20, 21, and 32 of The Banking Act, which when referring to these specific sections constitutes The Glass-Steagall Act, revoked all of the securities powers of every Federal Reserve member bank except for their capacity to dealing with government securities. Section 20 specifically ordered that no member bank could be affiliated in any form with any company that was engaged principally in the 'issue, flotation, underwriting, public sale or distribution at wholesale or retail through syndicate participation of stocks, bonds, debentures, notes or

[21] For an insight into the life of Ferdinand Pecora and his involvement with the investigation see Michael Perino *The Hellhound of Wall Street: How Ferdinand Pecora's Investigations of the Great Crash Forever Changed American Finance* (The Penguin Press 2010).
[22] Crockett et al (n 17).
[23] For just one resource that details the evolution of the 'New Deal' see Michael Hiltzik *The New Deal* (Simon and Schuster 2012).

other securities. Section 21 made it illegal for investment banks to accept deposits, and Section 32 stipulated that no bank officer or director could be associated with any business engaged in these activities'[24]. This prohibition, when combined with the Act's creation of a Federal deposit protection scheme which sought to end runs on member banks[25], represents a particularly strong public-protection approach that was incorporated by the Roosevelt administration and US Congress.

However, whilst this prohibition represents a robust challenge to the domination of the financial sector, a facet perhaps proven by the Act's influence continuing in place for over 60 years before the deregulatory era of the 1990s[26], many have found flaws in this crucial period for State intervention. The practical element of the State using its inherent power of intervention is the element from this era that this thesis is most concerned with. Yet, it is this element that many have criticised, and understanding why will be important for our own proposal.

The first element that is important for our consideration is that the forced separation in an industry dictates that some members of the industry, as it was, may migrate into the newly created industry, which then leaves a trail between the two which has the potential to create conflicts. For example, Markham describes how the separation between commercial and investment banking, which dictated that Universal banks must choose between being recognised as one or the other, resulted in the separation of key personnel that maintained close links with their former counterparts. When J.P. Morgan separated and became known as J.P. Morgan & Co., a commercial bank, the new entity that moved into investment banking,

[24] Crockett et al (n 17) 65.
[25] Murray N Rothbard *History of Money and Banking in the United States: The Colonial Era to World War II* (Ludwig von Mises Institute 2002) 315.
[26] The Federal Reserve did begin to erode the effectiveness of the Act in the 1970s however, by allowing security-issuing subsidiaries of holding bank companies to transact with securities that were deemed ineligible by the Acts of the 1930s, see Fabio Braggion 'Glass-Steagall Act' in Joel Mokyr *The Oxford Encyclopedia of Economic History* (OUP 2003) 423.

Morgan Stanley & Co., consisted of three of the original J.P. Morgan & Co. partners. Apart from the partners in the new firm, Henry S. Morgan, son of J.P. 'Jack' Morgan Jr., Harold Stanley and William Ewing, the majority of the other employees were also from J.P. Morgan, which leads Markham to state that 'although Morgan Stanley was supposed to operate independently of J.P. Morgan & Co., they were closely linked'[27]. This raises an important issue for the proposal regarding the forced separation of the ancillary services of the rating agencies: what is the best way to move forward *after* the separation; forced divesture, or separation which then creates a new industry that is *potentially* closely aligned to the rating industry? This will be a very important consideration for the reform proposal.

The second issue with these regulations, as developed in the literature, is that the actions have been considered to be politically motivated. The reason why this view has become prevalent is because modern analyses have found that there were very few links between the aspects of a bank that made it a 'universal bank' i.e. the collaboration between investment and commercial divisions, and the Crash of 1929 or the subsequent Depression[28]. Perhaps the leading scholar in this regard, who has had an enormous influence upon free-market and anti-regulation advocates like Charles Calomiris as we saw earlier, is George J Benston. Benston, in his work *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered*, describes a number of very important flaws with the investigation into the responsibility of the banks in causing the crisis, and also flaws within the regulations themselves. Ultimately, Benston concludes that there was very little evidence that could have emanated from the conduct of the Universal Banks because there are simply very few flaws in the Universal Banking model, and that in fact the fault lies with central

[27] Markham (n 16) 169.
[28] Braggion (n 26).

banks[29]. Benston's work initiated further research by scholars such as Kroszner and Rajan, Ang and Richardson, and Puri, who all found that, through assessing the default rates of bonds underwritten by Universal banks, the bonds were *less* likely to default than those underwritten by any other type of bank[30].

So, the enactment of regulations that were as impactful as the New Deal regulations, based upon very little evidence, has led scholars to suggest that the enactment of the Acts was politically motivated. Murray Rothbard claims that the attack upon investment banks that also accepted deposits, of which J.P. Morgan & Co. was easily the largest and as a result perhaps the most influential bank, represented a direct attack upon the House of Morgan. Rothbard attributes this purposeful attack on the House of Morgan to the Rockefellers, who forged alliances with leading Senators like Carter Glass, and also leading economic theoreticians like H. Parker Willis, who themselves were not enamoured with the dominance displayed by the House of Morgan even after the death of John Pierpont Morgan in 1913. This approach led to what some scholars have labelled as the 'cartelisation' of the banking industry, in that the Sections of the 1933 Act that forced separation 'helped the commercial bankers get rid of unprofitable securities, and to eliminate the powerful competition of investment bankers for customers' deposits'[31], which would seem to be confirmed by J.P. Morgan & Co.'s decision to opt for continuing practice within commercial banking rather than investment banking.

The economic analyses point to a regulatory phase which was built upon very little evidence, which arguably suggests that the State sought to dismantle the banking system as it stood on

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[29] Benston draws eight conclusions from his findings that suggest that the model of universal banking is economically advantageous and should be encouraged, see George J Benston *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered* (MacMillan 1990).

[30] This quantitative analysis is represented by the works of James S Ang and Terry Richardson 'The Underwriting Experience of Commercial Bank Affiliates prior to the Glass-Steagall Act: A Reexamination of Evidence for the Passage of the Act' [1994] 18 Journal of Banking & Finance 2; Randall S Kroszner and Raghuram G Rajan 'Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933' [1994] 84 The American Economic Review 4; Manju Puri 'The Long-Term Default Performance of Bank-Underwritten Security Issues' [1994] 18 Journal of Banking & Finance 2.

[31] Rothbard (n 25) 317.

the back of public anger. Whilst this has received a lot of criticism from onlookers, another angle that could be promoted is that when faced with such an entrenched and resourceful adversary, the only option available to the State who wants to protect the public against such a behemoth (theoretically speaking) is to utilise the public anger that emanates from a once-in-a-generation event to bring about such impactful changes. Though unethical because of the fabrication of culpability, there is an argument to be made that this approach is necessary when facing such entities. However, the redistribution of power rather than the removal of power suggests that this arguably unethical but effective approach was not what occurred in 1933; the theory of an attack upon the House of Morgan is incredibly convincing, and also the inaction of the State after the next once-in-a-generation event, the Financial Crisis of 2007/08, suggests that the State does not take advantage of such enormous events to bring about impactful change against an embedded financial sector.

As was mentioned earlier, the New Deal represented the beginning of ‘the Quiet Period’, which shines a positive historical light upon that particular period of regulation, and in essence the notion of forced separation. Alternatively, the period simply redistributed the power within the sector, which was combined with a *reversible* legislative approach (as demonstrated by the deregulation in the 1990s), which would eventually cumulate in the banking industry becoming protected to a degree whereby they are now immune to failure. For our proposal the aspect of the process being subjected to internal politics is the most troubling and certainly needs to be considered; the process cannot be hijacked by rating agencies and their respective lobbyists who would want to create a system that serves them eventually. Therefore, the reform needs to be absolute and *irreversible* to guarantee the separation for the sake of the public, because while the New Deal regulations represent an instance whereby the financial sector, the banking industry in this case, was forced to remove additional aspects of its business to protect the public, the *actual* version of events shows a redistribution of power that eventually led to the cementation of an industry within society; this cannot be repeated.

6.3.2 The Forced Divesture of Consultancy Services within the Public Accounting Industry – 2002

The events of the New Deal era showed that the State can intervene in the business of the private sector, and intervene to an extent where the actual business that one can provide can be dictated. This is an important understanding because it sets a precedent for future crises in that the fact that this method is an option for the state should weigh heavily on the minds of the leaders in the private sector (particularly in the financial sector). However, this aspect of private-social relations is clearly not considered when we look back over the history of the financial sector since the New Deal, and nowhere is this more apparent (before the Credit Rating Industry example at least) than with the accounting industry's adoption of consultancy divisions. Financial crises usually have some element within them that can be compared to previous crises and, just like with the blaming of Universal banking for the Wall Street Crash of 1929 and the Great Depression, the accounting industry's adoption of consultancy (additional) services has been directly blamed for the crisis emanating from the then-record bankruptcy of Enron, and later WorldCom[32].

For our analysis, the examination of the accounting industry is much more applicable than the examination of the banking industry during the 1930s. The examination of the New Deal regulations allowed us to see the first substantial example of the State wielding its power against the financial sector by enacting laws, developing programs for stability and even

[32] Kathryn Cearns 'Auditors and International Financial Reporting' in Carien van Mourik and Peter Walton *The Routledge Companion to Accounting, Reporting and Regulation* (Routledge 2013) 386.

creating new regulators to govern the marketplace (the SEC). However, investment banking, by definition, is not the best example of rent-harvesting like we know the CRA's adoption of ancillary services represents. What is a good example of another industry creating rent-harvesting divisions, and then subsequently being regulated for it, is the accounting industry's adoption of consultancy services.

The accounting industry's adoption of consultancy services and the effect of those services upon its capability to be an effective gatekeeper are extensively covered within the literature[33]. Chief amongst this coverage are the analyses of the conduct of Arthur Andersen, a prominent accounting firm that collapsed as a result of the Enron affair, which in essence initiated the public vilification of public accounting companies and heralded a new era with the enactment of the Sarbanes-Oxley Act in 2002. Just like the rating agencies after it, the accounting industry developed their consultancy service divisions purposefully to take advantage of their central position within the procedure of the financial sector. Yet, accountants are older, more central to the economy, and most importantly more visible to the public than the rating agencies will ever be, which is reflected in their revenues when compared to the revenues recorded by the Big Two Rating agencies[34]; so whilst the adoption of consultancy services by the accounting industry is broadly similar to that of the rating industry's adoption of ancillary services, there are crucial differences like size, role, and public perception that will need to be considered when making any comparisons.

The accounting firms were developing their additional services at such a rate that regulators and legislators began to take notice because, as Cearns notes, they 'became nervous in the

[33] For what can only be just a representative view see N C Smith and Michelle Quirk 'From Grace to Disgrace: The Rise and Fall of Arthur Andersen' [2004] 1 Journal of Business Ethics Education 1; Barbara L Toffler and Jennifer Reingold *Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen* (Currency/Doubleday 2004); Bethany McLean and Peter Elkind *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (Penguin 2004); John C Coffee *Gatekeepers: The Professions and Corporate Governance* (OUP 2006).
[34] The annual global revenues for the Big Four in 2015 were: E&Y $28.7 billion; PwC $35.4 billion; KPMG $24.44; and Deloitte $35.2 billion.

1990s that the firms were providing such a wide range of services that there was a risk that the central function of audit, a key governance plank underpinning markets and built into both corporate and securities law in highly regulated markets, would become a poor relation'[35]; this fear was not unfounded because Arthur Andersen, a firm that was central to the fraudulent rise of the Enron Corporation, was recording revenues from consultancy at the end of the 1990s that amounted to a massive 44% of their total revenue[36]. Now that the firms had developed a wide array of additional services, ranging from computing and business process advice to actuarial and surveying services, and also that these services were becoming more lucrative than their foundational purpose of performing third-party audits, the State decided to act with the Sarbanes-Oxley Act of 2002. However, a key point of note here is that even though both legislators and regulators were aware of the impending issue of the firms being conflicted to a point where their integrity was seriously in question, they still did not act. What it took for them to act was the collapsing of a number of colossal firms and this is representative of the double-edged sword that is financial policy making; there is not enough political capital to enact an impactful regulatory reform in a boom period and there is the pressing need to stabilise the economy in the immediate aftermath of a crisis, which obviously dictates that there is very little room for the considered implementation of a forward-thinking and socially-concerned reform at any point in the economic cycle. This is a point that will be considered when we look at the impediments for success for the reform proposal.

Bankruptcies are classified by the amount of assets the company had when it filed for bankruptcy protection[37] and the numbers concerning the bankruptcies at the beginning of the 2000s are quite extraordinary, although as we know they would be dwarfed by the collapse of

[35] Cearns (n 32).
[36] Coffee (n 33) 149.
[37] ibid 47.

Lehman Brothers in 2008. Nevertheless, Enron filed for bankruptcy protection on December 2nd 2001 and had over $65 billion in assets, whilst the filing for bankruptcy protection for WorldCom on July 21st 2002 went one step further and set the (then) record of $103 billion in assets. Such systemically impactful failures would be the trigger for the interventionist actions of the State, along with the revelations regarding the complicity of the accounting industry in helping to conceal enormous losses within these failed corporations.

On July 30th 2002, just 9 days after the record filing for bankruptcy protection from WorldCom, the United States enacted the Sarbanes-Oxley Act of 2002. Founded upon massive sentiments such as that articulated by President George W. Bush: 'No Boardroom in America is above or beyond the law'[38], the Act sought to address the weaknesses within the corporate governance framework, chief amongst which was the introduction of new standards for those who audit large publicly listed companies[39]. To do this the Act introduced the Public Company Accounting Oversight Board (PCAOB) which was tasked with overseeing the audit firms and was also given the capacity to discipline breaches as it found them; for our analysis Title II of the Act is the most important as it covers the issue of 'auditor independence' which is directly related to our analysis of the credit rating agencies' independence.

Title II serves as the reason for the evaluation of Moeller when he states that 'the overall theme under SOX is that external auditors are authorised to audit the financial statements of their client enterprises and that is about all' because ultimately the Act, through Section II, made it illegal for a firm to contemporaneously perform both audit and non-audit services for

[38] Max H Bazerman and Michael Watkins *Predictable Surprises: The Disasters You Should Have Seen Coming, and How To Prevent Them* (Harvard Business Press 2004) 63.
[39] Cearns (n 32).

a given client[40]. The Act determined that the non-audit services that were to be prohibited were: bookkeeping services; financial information systems design and implementation; appraisal or valuation services; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment advisor, or investment banking services; legal and expert services unrelated to the audit; and any other service that the PCAOB determines, by regulation[41]. A number of conclusions can be drawn from these rulings that are very important for our own analysis. Firstly, it is clear to see that the additional service divisions that were in operation prior to the enactment of the Act were no longer viable, and secondly, the Act gave the PCAOB enormous powers of discretion when it came to what may be deemed as prohibited non-audit services, which of course is an important step for the new regulatory body.

At first glance this regulatory approach seems to be just what was needed to remove the rent-harvesting elements of these socially important businesses. However, whereas the issue for this thesis when discussing the rating industry is the industry's capacity to negate the disciplinary measures of the state via the income from their rent-harvesting divisions, the issue with the accounting industry was primarily (and still is in reality) the need to change the culture within the industry, so that accuracy which then translates to stability is at the forefront of their operations. The culture within this socially-vital industry was warped however, as Garner et al explain:

> There has been a change in the firms' reason for being. The firms were now growth and profit oriented. Public duties, responsibilities, and professionalism were no longer the focus and hallmark. It was no longer central to provide the assurance needed by the market that clients' financial statements were fairly presented. Instead audit

[40] Robert R Moeller *Sarbanes-Oxley Internal Controls: Effective Auditing with AS5, CobiT, and ITIL* (John Wiley & Sons 2008) 26.
[41] *Sarbanes-Oxley Act of 2002* 116 Stat. 745 Title II 'Auditor Independence'.

service was seen as commodity-like and used to advantage as a loss leader for lucrative consulting work…[42].

This notion of 'public' is very important when attempting to understand the decisions of the legislators. As Garner et al stated above, and as Brewster reaffirms in his work *Unaccountable: How the Accounting Profession Forfeited a Public Trust*, the notion of 'public service' is engrained within the purpose of the public accounting industry[43]. The industry has even been called the 'guardians of the public interest' by some scholars[44], which points to the fact that everything must be done to maintain the industry's '*Independence in Appearance*', which Cottell describes as the most important aspect of any financial gatekeeper[45]. When we compare this situation with that of the rating industry, it is abundantly clear that the accounting industry is prominent in the public eye when the notion of corporate governance and financial safety is invoked, whereas while the ratings of agencies may be common parlance i.e. 'Triple-A', the actual role, function, and position of the industry is usually reserved for those with an interest in the markets or followers of business news outlets; this will have to be considered when we assess the likelihood of the proposal being implemented because the lack of a public presence may potentially be the deciding factor when legislators debate whether direct intervention is appropriate.

These are all key lessons that we can draw from the example of the early 2000s. However, whilst it is important to recognise the unique aspects that had an influence upon the thinking of legislators, what is vital is that we understand the similarities and the potentially

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[42] Don E Garner, David L McKee, and Yosra A McKee *Accounting and the Global Economy after Sarbanes-Oxley* (Routledge 2014) 18.
[43] Mike Brewster *Unaccountable: How the Accounting Profession Forfeited a Public Trust* (John Wiley & Sons 2003) 5.
[44] Megan S McDougald and Royston Greenwood 'Cuckoo in the Nest? The Rise of Management Consulting in Large Accounting Firms' in Matthias Kipping and Timothy Clark *The Oxford Handbook of Management Consulting* (OUP 2012) 111.
[45] Philip G Cottell 'The Public Accounting Industry' in James Brock *The Structure of American Industry: Twelfth Edition* (Waveland Press 2013) 349.

transferrable lessons that we can learn from the mistakes of the early 2000s. The structure of the accounting industry was, and still is very similar to that of the ratings industry. One scholar has suggested that the accounting industry is representative of a cartelised industry because competitive pressures do not ensue in the face of a lower quality output, and also that the ability to use the original output as a loss-leader for the sale of additional service is only possible when a firm is part of an oligopoly[46]; the similarities to the ratings industry is clear.

In short, whilst the Sarbanes-Oxley Act seems to represent a massive triumph for the public against the limitless greed of a key financial sector, the *actual* version of events tells of a process that was dogged by lobbying efforts and compromises designed to allow for the future development of sustained rent-harvesting by the industry. The earlier attempts to limit the provision of consultancy services, that would have in effect made the dramatic collapse of Enron much less likely, were stonewalled by the American Institute of Certified Public Accountants (AICPA)[47]. In the lead up to Sarbanes-Oxley, which was just days after the record collapse of WorldCom lest we forget, three out of the five global accounting firms, in the words of former SEC Chairman Bevis Longstreth, 'representing solely their private business interests, rejected any meaningful restrictions on the free play of those interests'[48]. Arthur Levitt, Chairman of the SEC from 1993 to 2000, was leading the development of the regulations against the accounting industry and believed that what was required was a clean break between auditing and consulting duties[49], although to his credit he was seeking to focus upon the *actual*, as Bazerman and Watkins explain: 'in fact, most of the Big Five firms were already taking steps toward spinning off their consulting divisions, whether by choice or by force… But Levitt as unimpressed by those spontaneous shows of independence. As soon as

[46] James D Cox 'The Oligopolistic Gatekeeper: The US Accounting Profession' in John Armour and Joseph A McCahery *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the U.S.* (Bloomsbury Publishing 2006) 316.
[47] Garner (n 42) 18.
[48] Dennis Caplan, Diane Janvrin, and James Kurtenbach 'Internal Audit Outsourcing: An Analysis of Self-Regulation by the Accounting Profession' [2007] 19 Research in Accounting Regulation 25.
[49] Bazerman and Watkins (n 38) 53.

Andersen's consulting limb was hacked off from the parent firm, a new, even bigger one sprouted in its place'[50], which is a particularly strong indicator of the nature of these socially important financial gatekeepers.

However, Levitt's focussing upon the *actual* was not consistent, as Bazerman and Watkins continue by describing the approach that Levitt decided was appropriate in that the firms would be able to continue providing additional services to non-audit clients, which he hypothesised would reduce the temptation of auditors to blindly accept their consulting clients' questionable accounting practices. By focusing upon the *perceived* nature of the firms, as opposed to their clear record of outright greed, Levitt underestimated the lengths at which the industry would go to ensure that consulting service provision would remain in some form, and would remain profitable. In 2000, Levitt was under considerable pressure to justify his position from leading Committee members, Representatives Tom Bliley (of the Gramm-Leach-Bliley Act), Michael Oxley (of the Sarbanes-Oxley Act) and W.J. (Billy) Tauzin, who would hound Levitt for the duration of the hearings; such congressional hearings into the rule-making of the SEC were unprecedented during Levitt's many years at the SEC which leads Bazerman and Watkins to conclude that Levitt had 'underestimated the attachment of the Big Five to their "integrated" audits, as well as their influence on Congress', and lead Levitt to conclude 'They waged a war against us, a total war'[51] – Levitt claims that he received *forty-five* letters from *Congressmen and Women* in support of the accounting industry on this matter.

The effect of this pressure upon the development of the law is clear to see. Rather than prohibiting *all* additional services, which was justified in response to two consecutive record failures in the space of 9 months, the law served to allow firms the ability to continue

[50] ibid.
[51] ibid 54.

providing these services except for when they are providing audit services to a particular client. The effectiveness of this approach can be seen with the benefit of hindsight. Rather than ushering in a new ‘Quiet Period’, the Sarbanes-Oxley Act encouraged the reduction of consultancy divisions within the top firms for approximately 5 years when the non-compete agreements held with the owners of the divisions that were sold had expired; the accounting firms are now actively rebuilding the consultancy divisions[52]. Even worse, the comfort in breaching laws that can only come with the protective barrier that additional services revenue provides was clearly evident when the leading firms were all involved in the scandalous sector-wide race-to-the-bottom during 2007 and 2008. PricewaterhouseCoopers has been sued for not revealing financial imbalances at AIG, recipient of $67.8 billion in TARP funds; Deloitte is alleged to have uncovered very little of the problematic asset valuations that led to the bankruptcy of Bear Sterns in 2008; Citibank’s misvaluations of synthetic financial products were not exposed by KPMG; and Ernst & Young had on numerous occasions ‘improperly’ assisted Lehman Brothers by helping it disguise its true financial condition[53]. These incredible instances of continued negligence in the search for profit at the expense of public safety should leave no one in any doubt as to the real nature of these firms.

Analysing this period was incredibly important for our understanding. This thesis is proposing to absolutely prohibit the provision of additional services by a socially crucial financial gatekeeper, and the reason why should be evidently clear now that we have looked at the appalling conduct of the accounting industry. The incessant quest for profits and growth, at the cost to society, is simply unacceptable. It is clear from what we know so far, from our analyses of the rating industry as well as the accounting and banking industries, that the leading participants have absolutely no regard for the safety of the public; so, this thesis is

[52] Harriet Agnew ‘Professional Services: Accounting for Change’ [2015] Financial Times (Aug. 27).
[53] Malcolm Campbell-Verduyn ‘Conflicts trends and tensions in post-crisis reforms of transnational accounting standards’ in Tony Porter *Transnational Financial Regulation After the Crisis* (Routledge 2014) 182.

attempting to turn the tables and show no regard for the continuation of their respective futures. The actions taken by the State, actions which were surely forced by the public perception of the role of the Public Accountant, were eventually watered down by a concerted lobbying campaign that allowed for the re-establishment of the same divisions some years later (admittedly not in the same form but equally as lucrative). The inexcusable culture remains because of the lack of a deterrent, which is an aspect that every scholar or concerned onlooker who assesses regulation should eventually consider; the question of 'what is the deterrent?' will always reveal the likelihood of misbehaviour.

Now that we have looked at two examples of State intervention, we can be confident in saying that *technically* State intervention is an option. However, we saw in the analyses that this intervention is consistently under attack by those the State is seeking to regulate, and that usually the subjects have managed to monetise their engrained position and then turn those resources upon the Public whom they serve. What follows then is a proposal that has been designed to redress the balance, to align the output of the ratings industry with the public interest, and ultimately to protect the public from the absolutely devastating effects of uninhibited greed. Yes there will be plenty of opposition to its implementation, but the action of devising a plan that is incremental, yet rooted in the ambition of promoting the protection of the public, makes it a worthwhile endeavour.

6.4 A Reform Proposal to Limit the Impact of the Ratings Industry upon Society

So far in this thesis we have endeavoured to understand the rating industry as it actually is, rather than how one may desire it to be. We have seen a number of instances where the industry *actively* operates against investors, issuers, the State, and most importantly of all the public. It is reasonable to suggest that a private firm should *prioritise* its own advancement, because if it does not then no one else will, but to extend beyond this mandate and actively harm others in order to achieve growth is not acceptable within an advanced society. When we looked at the revenue figures for Moody's earlier, we saw how the revenues garnered from credit ratings have rebounded well after the Crisis and remain as the foundation for the company; the question is 'why is this revenue stream not enough?'

Of course, we cannot dictate to a private company how much it can earn. But, what we can do, as evidenced by legislators in 1933 and 2002, is dictate *how* a private company can earn, which is what this proposal aims to do. The credit rating industry is vital in today's economy that is centred upon the issuance of debt, so it is important to preserve and protect the rating abilities of the largest agencies. Rather than preserving and protecting this ability, it is preferable to propose a system whereby the quality of the ratings can actually be increased, which is a by-product of this proposal.

The proposal advanced here has been mentioned throughout this thesis so, in order to be clear, the reform proposal can be simplified by stating that it calls for the '*complete and irreversible prohibition of the provision of additional services by credit rating agencies*'. There has been enough evidence put forward so far to support this proposal as it is stated above, although in an attempt to counter the claims that may be made against it we shall now look at the individual components that comprise the reform proposal and aim to make it *absolute* and *irreversible*.

Absolute Prohibition

In its 2003 report to Congress regarding the agencies' independence, the SEC made an interesting point regarding the models adopted by the industry: 'ancillary services are in some cases provided by the NRSRO, a *non*-NRSRO affiliate of the NRSRO, or in other cases, by both the NRSRO and a non-NRSRO affiliate'. The SEC report continues by stating that Section 15E imposes requirements only upon the NRSRO and *rating*-affiliates designated by the NRSRO on its Form NRSRO, thus 'the Staff's ability under the current Commission rules directly to obtain information regarding, and to examine, the effectiveness of policies and procedures could be affected by the choice of a non-NRSRO affiliate to provide such Ancillary Services'[54]. It is precisely matters like these that we need to consider, as it details the *actual* state of the industry as opposed to how we imagine it should be.

Therefore, the first aspect of the proposal is that **no NRSRO, nor its holding company, can have any stake in a company (or division) that provides 'additional services', nor can it have any 'affiliate' associated with it that provides 'additional services'**. The definition of 'additional services' here is rather simple; **any service that is not a credit rating is deemed to be an 'additional service', and is to be prohibited**. Moody's promotes the sales of what it calls 'special reports' on its Moody's Investors Service website i.e. not Moody's Analytics, that contains such elements as industry and sector outlooks, as well as outlooks by region; these services *can* be important to investors, but they are for sale and are not free. The initial cost of one of these reports is $750, which to an institutional investor is a very low cost indeed, but may be expensive for a retail investor. However, institutional investors will not base their investment decisions on the basis of a $750 report, and with the separation of

[54] Securities and Exchange Commission *Report to Congress: Credit Rating Agency Independence Study* (2013) 20.

ancillary services from credit rating services anticipated to create a new, albeit much smaller market, the retail investor will be able to purchase that information from another source (there are already market forecasting companies in existence); **for this reason 'special reports' will also be prohibited**.

According to Moody's website anyone can have 'free' access to 'Issuer Ratings, Events Calendars, Watchlists, and Rating Methodologies', which according to this reform proposal is all that the company will be able to offer. The information contained within the ratings, the watchlists, and the methodologies, is all that an investor really needs from a rating agency i.e. what rating they have ascribed to an issuer, the short- to medium-term prospects of that rating remaining the same, and the method with which the agency came to that particular decision. Only the equivalent services offered by other NRSROs, taking into account differences in title, will be allowed to be provided by a rating agency, irrespective of market capitalisation.

Whilst one may argue that to prohibit *all* non-essential services may be extreme, the prohibition is based on two elements. Firstly, the rating agencies have demonstrated consistently that they *only* seek to maximise their profit, so allowing for a reduced revenue stream will soon be countered by lobbying or reorganisation efforts so that the small gap left by regulation is opened up and exploited. Similarly, the SEC cannot be trusted to put the public at the forefront of its mind-set and remain steadfast in the face of what is sure to be inevitable pressure from the agencies and their supporters. For this reason, the prohibition will be **absolute**, and we shall see shortly that it has to be **irreversible** to counter this inevitable counter by the industry.

The Right to Choose

Like the separation enforced in 1933, the next stage of the reform proposal is that the agencies will be given a choice; **either provide credit rating services only, or provide ancillary services only, but not both.** Although the side-business of ancillary service provision is clearly not the same as investment banking was to the universal banks, the option will still be put forward to the agencies to choose their line of business moving forward. If, as the agencies are adamant, the provision of ancillary service's value is not tied to the presence of the rating division, then this should not be as spurious an option as it first sounds; lest we forget this is a multi-billion dollar industry at present. However, unlike 1933, the agencies **will not be allowed to create rebranded ancillary service divisions and have partners move across from one industry to the other**. Rather, the line of business that they decline will have to be divested, as we shall discuss next.

Divesture

After the agency chooses which line of business it would like to remain in, with it being highly anticipated that all NRSROs will choose to remain in the rating field, the next stage of the reform is that they will have a **maximum of 2 calendar years from the date of enactment to divest the declined business entirely**. The sole reason for this limitation, in addition to the point made earlier regarding rebranding and the continuation of close links between the old and new companies, is that the lobbying efforts by the agencies, even after enactment, would be extraordinary. Based upon what we have heard so far about this sector, and indeed almost every other financial sector, the longer it takes to implement the changes that are required, the higher the chance there is that lobbying efforts will dilute the intended effects, ultimately rendering the proposed reform inadequate.

In the event that the NRSRO does not divest the division, and indeed any affiliate, completely within the two-year period, **administrators will be appointed to complete the sale, in a manner akin to bankruptcy proceedings.** The market-research market has enough businesses within it to allow for the sale of the components of the divisions at a price that is not punitive to the rating agencies, so the deadline is fair and the penalties for not abiding by it are also fair.

Irreversibility

Unlike the Sarbanes-Oxley Act of 2002 that mandated that certain aspects of additional services as provided by accounting firms were to be prohibited, which encouraged the firms to divest their additional service divisions, this reform proposal has *clearly* prohibited the providing of any additional services by rating agencies. In order to counter the inevitable backlash, and cover for all caveats, the next stage of the reform is to articulate that **any service other than credit rating provision, the publication of watchlists, and of rating methodologies, are expressly prohibited**. This has the effect of prohibiting any provision of additional services under a different title, like ‘advisory services’ for example. **There are to be no exceptions to this rule**.

This aspect of the reform puts an end to any hopes that the agencies would have of following the lead of the accounting counterparts and establishing short-term ‘non-competes’ with the buyers of the ancillary divisions, so that the illusion of prohibition is met whilst the long-term aim is to continue with the provision at a later date when the economic cycle is more hospitable to private expansion.

These simple elements of absolute prohibition, the ability to choose which business one wants to operate in, a two-year deadline for divesture, and the articulation of irreversibility within the reform, would all achieve the aim of removing the rent-harvesting division of the rating agencies and aligning them closer to the public interest. However, in this thesis we have looked at a number of different angles concerning the rating industry and one thing should stand out above all else; things are not as simple as they appear. Whilst this reform has the potential to be effective, mostly through its simplicity, there is a need to address the *actualities* that would stem from this proposal. So, we shall now assess the potential advantages that could stem from the implementation of this reform proposal. Yet, in keeping with the call to assess the *actual* we shall also address the potential impediments to the implementation of this reform, because to challenge such an engrained and resourceful opponent will always be an extraordinarily difficult task.

6.4.1 Potential Benefits of the Implementation of the Reform Proposal

There are a number of potential benefits that come with the implementation of this proposal. Although every party that is concerned with the ratings industry, including the agencies themselves, can benefit from the effects of the proposal, the benefits for the agencies is predicated upon their accepting of a short-term loss for long-term stability; whether they have the capacity to do this is not known, although all the evidence points to an industry that is mindful of its historical brushes with extinction, and as such has become ruthless in its attempt to survive – showing how the agencies can cement their position within the economy *and* contribute to the development of society at the same time is the key challenge for this proposal.

The first point to make is that this proposal does not take the agencies out of business, as other proposals aim to do[55]. This is an important element because it would leave the agencies (using Moody's as an example) with a revenue stream in the region of $2 billion annually as it stands today, which is still an incredible position to be in. What is more important perhaps is that one element of the conflicts which hound the industry would have been entirely removed, so the *independence in appearance* will be increased considerably; this stands to be potentially more profitable than the provision of ancillary services in the long-term because the increasingly negative reputation the agencies are garnering at present will surely reach a breaking point at some point in the future, perhaps when their complicity in a crisis larger than 2007/08 forces the hand of legislators, albeit in a less conciliatory tone than this proposal – it is not unreasonable to foresee this chain of events.

This increase in reputation stemming from the implementation of the reform proposal would be enhanced further by the understanding that the removal of additional services *tends* to result in an increased focus on the gatekeeper's primary function. However, this aspect needs to be understood in context; in relation to the response of the accounting industry to the prohibition on additional services, Cottell tells us that the firms began to pay more attention to the risk profiles of their clients as a response to the legislative attack on their business[56], which is clearly desirable. Yet, we know from 6.3.1 *The Forced Divesture of Consultancy Services within the Public Accounting Industry – 2002* that the accounting firms were still

[55] See 3.2 *The Oligopolistic Structure of the Ratings Industry* for just some of the proposals aimed at taking the industry out of existence.
[56] Philip G Cottell 'The Public Accounting Industry' in James Brock *The Structure of American Industry: Twelfth Edition* (Waveland Press 2013) 352.

assisting large corporations with their fraud just seven years after the Enron scandal; so it must be stated that this notion of the rating agencies focussing more upon the quality of their ratings as a result of not providing ancillary services is *desired*, but a consideration of their *actual* constitution may force us to temper our hope in this regard. Also, we have seen on a number of occasions that the agencies hold their reputation, in *actual* terms, in very little regard, so appealing to this aspect of the agencies is not guaranteed to be effective.

For the issuers, the removal of additional services has a number of potential benefits, particularly if we accept that certain conditions exist. If the provision of ancillary services is being used by the agencies to harvest rent, which this thesis claims is the case, then the obvious conclusion that can then be made is that issuers (and subsequently investors) are the ones paying this rent to the agencies. In addition to this reduction in cost for issuers, the *theoretical* understanding that the issuers are not *technically* bound to the agencies means that the agencies would not be able to attempt to offset the losses experienced through the prohibition of ancillary service provision by raising the prices of their ratings. As opposed to the accounting market whereby publicly listed companies must be audited (the accounting firms did increase their prices post-SOX[57]), the rating market is constricted by pricing pressures which means the agencies cannot simply alter their prices to suit their needs; it is not hard to imagine that large issuers would not take kindly to an increase in price, even by one or two basis points. Again however this benefit must be placed in context because it operates on the *desired* version of events being true, when we know that the *actuality* is that the issuers are still bound to the agencies even after Dodd-Frank, which means there is a potential for the agencies to pass the losses onto their customers (although this would arguably still be less than subscription to the ancillary services – the issue then would be that the issuers cannot buy favour or protection).

[57] ibid 350.

However, the aim of this reform proposal was not to appease the agencies, but to protect the public and in this regard the objective would be achieved. The absolute and irreversible prohibition on additional services results in the limitation of the potential resources that agencies can use to negate any disciplinary measures that may be taken against it. This concept of protecting the public has to be at the forefront of everyone's thinking, because rather than a financial crash affecting the bottom lines of large multinational corporations, the Financial Crisis, which we know the rating agencies directly facilitated (amongst others), has resulted in the increase of global poverty[58], homelessness[59], and suicides[60], amongst a host of other societal ills; it is not farfetched to make this connection, and in fact is important for the future of society that this connection is made whenever possible.

The State may have opted to remove the deterrent of custodial sentences from the upper echelons of the financial sector, but even though this awful development has made the prospect of protecting the public that much more difficult, there is a way in which the weak deterrent chosen by the State can be turned to the public's advantage, and that, with regard to the rating industry, is to remove its rent-harvesting division and expose it, to a greater extent, to the fines that are given to it. Franklin Strier agrees with this position, and in what seems like a fitting way to end this section, he states:

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[58] Overseas Development Institute *The Global Financial Crisis: Poverty and Social Protection* (ODI 2009); Bilal Habib, Ambar Narayan, Sergio Olivieri, and Carolina Sanchez-Paramo *The Impact of the Financial Crisis on Poverty and Income Distribution: Insights from Simulations in Selected Countries* (Centre for Economic Policy Research 2010).
[59] Nicole Fondeville and Terry Ward *Homelessness During the Crisis: Research Note 8/2011* (European Commission 2011).
[60] Karen McVeigh 'Austerity a factor in rising suicide rate among UK Men – Study' [2015] The Guardian (Nov. 12).

> The rating agencies' loss (in consulting revenue) could be the public's gain… From a utilitarian viewpoint, the loss of rating agency fees pales before the projected public good of more independent rating agencies[61].

6.4.2 Potential Impediments to the Implementation of the Reform Proposal

There are indeed a number of benefits that could come with the implementation of this reform proposal. However, actually getting the reform proposal implemented in the first place is an entirely different matter altogether. This thesis has attempted to provide the context for the need for this reform by examining the majority of issues that surround the ratings industry today (and historically to a certain extent). As a result, we have been able to understand that the ratings industry is a particularly mighty adversary to the public interest. Not only does it amass incredible resources through the conflict-laden issuer-pays remuneration model, as well as the rent-harvesting ancillary service divisions, but it has also been embedded within the modern economy, so much so that apparently generation-defining legislative attempts to remove the binds that keep the industry wedded to the modern economy *have had no effect* on the fortunes of the industry and on its position within the economy. This thesis has endeavoured to promote a new understanding of the ratings industry in that we have to consider the industry for what it *actually* is, rather than what we may *desire* it to be, and in that light it is important that we attempt to ascertain the potential impediments to the adoption of this reform proposal.

The most obvious impediment to adoption of the reform would be the mobilisation of the industry's vast resources which, in reality, has and will again stymie impactful reform

[61] Franklin Strier 'Rating the Raters: Conflicts of Interest in the Credit Rating Firms' [2008] 113 Business and Society Review 4 546.

proposals. We have seen evidence in this thesis that almost guarantees that the Big Three, if not other members of the rating industry, would mobilise their considerable resources to instigate a concerted and effective lobbying campaign[62]; if they mobilised for Dodd-Frank, they would certainly mobilise to protect their ancillary service divisions. Moreover, we have also seen evidence of this tactic being used across the financial sector, from banks to accountants, which shows the opposition that would almost certainly be presented.

This lobbying campaign brings into focus another issue and that is the susceptibility of leading political figures to be captured by private interests. We saw in 6.3.1 *The Forced Divesture of Consultancy Services within the Public Accounting Industry – 2002* that the mobilisation of the accounting industry's resources to fund a concerted lobbying campaign led to a large number of *U.S. Congress Men and Women* coming out in support of the firms' ability to provide additional services that were at the very heart of two record financial catastrophes[63]; the implication is truly staggering. The implication is staggering because for any impactful reform to be implemented we will need the support of precisely those people who are being captured by private interests, so the imagining of a Faustian situation is particularly apt when considering the choices facing these leading politicians.

Also, the SEC has been admonished by this thesis for being weak with their administering of penalties for breaches of the law[64], which raises another issue; the absolute removal of ancillary service divisions, based upon the need to remove the nullifying effects of the resources generated by the provision, but also upon of the inability of the SEC to effectively contain the naturally exploitative demeanour of the agencies, means that the adoption of the reform would be a massive blow to the reputation of the SEC. It is certainly not unreasonable

[62] See 4.3 *A Reality Check* (n 33).
[63] 6.3.1 (n 52).
[64] 6.2 *The Imperfections in the Current Framework Governing Ancillary Service Provision*.

to ask the question of how supportive the SEC would be of such a proposal given the reputation capital they would lose as a result.

In the most recent analyses of the accounting industry's rebuilding of their consultancy services we can see a trend that would be directly applicable to this reform if it were not applied in an absolute fashion. Business journalists have noted that the firms were able to continue their operations because the prohibiting rules only applied to the U.S. Jurisdiction[65], which brings about another issue for our reform proposal, because the reform simply cannot be adopted in a fragmented fashion – it is an all-or-nothing reform. The issue it raises is that for the nullifying effect of ancillary service divisions to be completely eradicated, the reform would have to be globally implemented, which for the ratings industry essentially means the implementation by the E.U. and the I.O.S.C.O. as well as the U.S. Though the anti-rating agency sentiment is high enough in the E.U., judging from their extensive reforms after the Crisis, these are still additional hurdles that the reform would have to pass, which would also allow the agencies further opportunities to scupper the reform.

However, irrespective of the resources that the agency would commit to the challenging of this reform, the hurdles that would be presented by the need to present a global front against the industry, and of the important aspect of timing (the regulatory fertile post-crisis era has passed), the biggest impediment to success lies in the minds of our societal leaders. It was mentioned earlier that the public perception of the accounting profession, when allied to the extraordinary failures that came as a direct result of the criminal actions of the accounting firms, forced the hands of our leaders to make a stand against the industry[66]; what we can draw from this analysis is that the public perception of the rating industry, which is simply not the same as the accounting industry, dictates that the leaders have not, and probably will

[65] Agnew (n 52).
[66] 6.3.2 *The Forced Divesture of Consultancy Services within the Public Accounting Industry – 2002*.

not have their hand forced by the failures of the industry, which is incredible given the extent of the damage caused by the rating industry. What this ultimately means is that the decision to implement impactful reforms of the rating industry will be down to the will of societal leaders to reject the financial benefits of being captured and strive to protect the public from the inherently destructive nature of the financial industry; whether one believes that this may happen is down to one's outlook, as has been demonstrated by the variance in opinion regarding the best way to advance our society i.e. free-market proponents as opposed to those arguing for stronger regulations for example, but one thing that is for sure is that there is little evidence of this will being demonstrated by those who are in the position to do so.

To counter this lack of willingness to protect the public from the iniquities of the financial sector, this thesis has proposed a reform proposal that is remarkably simple, but which is based upon clear evidence of wrongdoing and rent-harvesting behaviour that in turn has the effect of negating any financial punishment. My claim is that the legitimacy of this reform, fundamentally, turns on a proper conception of the role of the financial sector within society. It is surely untenable to suggest that society is there to serve the financial sector. In fact, it is the other way around and this is a sentiment that must be remembered at all times, regardless of the personal benefits that come with ignoring it. This thesis has demonstrated very clearly the past dangers of ignoring the proper relationship between the role of the financial sector and the interests of society. To fail to address this risks repeating the mistakes of the past, and leaves this and future generations susceptible to a crash that society will perhaps not be able to recover from.

6.5 Conclusion

The aim of this chapter was to present the raison d'être for this thesis. In attempting to present a reform proposal that would align the output of the rating industry closer to what is required by the public, the chapter contained the details of the call for the absolute and irreversible prohibition of the provision of additional services by credit rating agencies. To give this proposal the best chance of being implemented the chapter sought to show the weaknesses within the current regulatory framework that governs the current provision of additional services, some historical instances of state intervention in private affairs, and ultimately the strengths and weaknesses of the proposal itself.

The current regulatory framework that governs the provision of additional services is incredibly weak. We saw how the framework is built upon concessions and collaboration, aspects that have resulted in the direct exploitation by the rating agencies. There are a number of rules that have been adopted by the SEC which seem to make sense, with the prohibition of contemporaneously providing rating and ancillary services being banned as mandated by the CRA Reform Act of 2006 providing a good example. This is positive, yet the mind-set of the SEC undermines any advances in this area. We saw a number of instances where the SEC's response to material violations of the law was the recommendation to change the behaviour that was causing the breach; this approach would not be accepted in any other form of the justice system, and ultimately is illustrative of the position of the SEC – it is difficult to provide a reasoned argument that says the SEC is championing the rights of the investor over the financial sector in this particular area.

The understanding of the weaknesses of the SEC is one of the underlying inspirations for the call for absolute prohibition; simply put, the SEC cannot be trusted to regulate a limited version of the provision of additional services. Based upon this same sentiment the chapter then moved onto look at some 'inspirations' for the call for prohibition, although the notion of these instances providing inspiration was tempered because each instance contains serious flaws. We saw how in 1933 the US State took on the powerful banking sector and enforced the break-up of the Universal Banks, so that the banks would either be commercial banks, or investment banks, but could no longer operate as both. Whilst the endeavour seemed a noble one that was aiming to address the public harm created by the sector, we saw how modern analyses points to the realisation that the evidence used to support such an unprecedented move was essentially fabricated. This realisation led to two potential understandings; either the State was seeking to cartelise the banking industry and attack the previously impervious House of Morgan, or the State was using the underhanded tactic of exaggerating evidence so that the all-powerful banking industry could be restrained on the basis of public anger. Whilst the second understanding is, in the viewpoint of this thesis, acceptable in those simplistic terms, because the protection of the public is the most important goal, the evidence compiled in this thesis alone suggests that the State does not operate for the protection of the Public. There are simply too many instances whereby the State has actively taken the lead in supporting the private sector in its assault upon society, which results in the realisation that the generation-defining 'New Deal' financial regulations represents the origin of the awful position we find ourselves in now with a banking industry *that cannot fail*; also, lest we forget, this era was the first time the rating agencies were incorporated into the financial regulatory framework.

The actions taken by the State in response to the Accounting industry's complicity in two of the biggest financial collapses on record at that point in 2002 represented the second instance of state intervention into the affairs of a financial industry. The most important aspect to take away from the analysis for our understanding is that the legislative process was incredibly weakened by a concerted lobbying campaign despite the increased levels of public anger. As a result, the legislators allowed for compromises to be included within the Sarbanes-Oxley Act that has allowed for the rebuilding of the very divisions the Act sought to dismantle. Additionally, the tempered approach had little effect upon the culture of the industry, with the leading proponents conducting themselves in the very same negligent manner just seven years later to the equally-destructive effect as seen in the early years of the new millennium; the lesson to be learned here is simple – one cannot negotiate with such entities. The conviction of the State must be absolute when regulating industries that are inherently self-interested and ruthless in securing their survival.

So, the reform proposal that aims to redress the imbalance within the rating industry's relationship with society was introduced in a simplistic and straightforward manner. The proposal, that agencies are absolutely prohibited from providing any service other than rating services, are forced to choose between continuing in the rating or market-research industry, and are banned from ever providing such services again, was developed to promote clarity in a field that has utilised conscious complexity for a number of years. We saw how the agencies would benefit in the long-run, how issuers would benefit, and most importantly how society would benefit immeasurably from a constrained ratings industry. However, whilst there were a number of benefits that came with the proposed reform there were also a large number of substantial impediments to its implementation, all of which hinted at inherently-systemic problems.

In order for such an impactful reform to be considered within the financial sector, the aspects that must change are simply incredible. The susceptibility of leading politicians to 'capture' is the biggest impediment by far, because any reform would have to be enacted by the very people who are susceptible. The difference between the accounting industry and the ratings industry, in that the accounting industry has much more of a public presence, is perhaps the leading component of the industry's ability to avoid impactful reforms. As we saw with the banking industry in 1933 and the accounting industry in 2002, the driving force with those reforms was the public anger that came from the crises created by the respective industries. However, Charles E Mitchell was something of a celebrity, and the public trials of Jeffrey Skilling and Arthur Andersen bosses brought them to the forefront of the public's thinking when related to financial issues; it is not hard to imagine that the asking of the question 'who is the CEO of Moody's Investors Service?' to a sample of the general public would be met with a muted response, and herein lies the issue.

What is required then is further research that is conducted upon two beliefs: the need to focus upon reality is paramount; and the need to widen the availability of that research is crucial. By developing honest and uncompromising research into these destructive industries, and then communicating that in as many public mediums as possible, the chances of enacting meaningful reform will rise dramatically when compared to the current situation. Whether the research is quantitative, qualitative, or normative, is immaterial - it must be based upon these two foundations; if it is, then it is conceivable that we will be in a much better position to hold up these destructive industries to the public for their derision when they inevitably become involved in the next societal breakdown. The shame of this lies in the many people who are currently experiencing extraordinary hardships as a result of these actors' callous disregard for society; in a just world they would be imprisoned for their crimes, but in this *actual* world we must be ready to develop public anger to a level that forces the hand of political leaders immediately after the next catastrophe – the increased education of the public to the iniquities of these areas of society is crucial.

Conclusion

There is a power generated by activism and committed campaigning for social goals[67]

This thesis endeavoured to assess the effectiveness of the discipline afforded to the rating agencies in light of their conduct before, during, and after the Financial Crisis of 2007/08. Inspired by the spectacle of the leading rating agencies recommencing their unprecedented growth just two years after the largest financial collapse since the Great Depression, the thesis aimed to understand how Standard & Poor's, as a representative of the Big Two, was able to absorb the 'record' financial penalty of $1.375 billion given to it by the US Department of Justice for knowingly defrauding investors in the lead-up to the Crisis.

After analysing the effectiveness of the legislative measures taken against the agencies, just two or three years before the height of the Crisis, this thesis can conclude that the rating agencies exploited their position by incorporating additional service divisions to 'harvest' profits from the sector that would lead the world to the brink of financial ruin; this is how the agencies were able to absorb the record penalties. Yet, the analysis conducted by this thesis revealed a far more pessimistic view in that investors, issuers, and indeed the state, all benefit from this warped anti-social arrangement. In fact, the only losers in this arrangement are the public, who have borne the brunt of the costs of this arrangement, and have suffered a distinct breakdown in the fabric of society as a result.

Whilst it would be easy to surrender to this reality and accept the role that the public must seemingly play in reaping no reward but receiving all of the costs, this thesis argues that by detailing this reality in clear and unobstructed terms there stands an opportunity to reverse this sentiment that has taken hold. By producing research of this nature, and then striving to disseminate as far as possible within the public realm, the hope is that the next financial

[67] Matthew Clement '1976 – the moral necessity of austerity' in Stella Maile and David Griffiths *Public Engagement and Social Science* (Policy Press 2014) 70.

collapse, and the regulatory response to the last one dictates that future collapses *will occur*, will take place within a world where the actors are widely known and vilified as a result. It is only by increasing the awareness of the schemes and participants of those schemes that seek to extract wealth from society can we stand a chance of reducing the public's exposure to the harm that inevitably comes with such a venal crusade.

So, in order to achieve that aim the thesis had a number of clearly defined research questions which when answered would paint the picture of a system that needs to be constrained for the *protection* of the public. In answering those research questions the reason for the prohibiting reform proposal was formed, in that it was revealed that to *trust* in the agencies, or indeed the regulators, to maintain a limited form of additional service provision was simply not a viable option based upon their history of exploiting gaps for their own gain, often at the expense of societal health.

The first question that was posed in the introduction to this piece was what is the current role and status of the rating industry, and why does that role require regulation? In order to answer that question effectively it was important that we had a sufficient knowledge of who the rating agencies that make up the industry actually are. To that end we were introduced to the agencies via a 'primer' which detailed for us the identity of the leading agencies, their organisational structures, and also their position within the industry, which in relation to the rating industry is an important consideration. It is important because we saw that the industry is dominated by 'The Big Three', although there is an argument that it is actually dominated by 'The Big Two': Standard & Poor's and Moody's. This basis understanding allowed us to move forward and look at the role the industry plays within the financial sector, and to achieve that goal the opening chapter analysed what the industry does for certain parties. We saw that, quintessentially, the industry serves a number of roles which includes signifying the health of a debt-issuing entity to the market, and also protecting confidential information so that the act of issuing debt to the market remains a viable and beneficial practice. In the second chapter, we also saw that the investor utilises the ratings of agencies to protect their position, mostly by way of using the ratings as gauges that can be inserted into debt agreements i.e. ratings triggers. Not only do issuers and investors depend on the agencies to lower their respective costs, but the state is arguably the biggest benefactor of this cost-reducing capacity of the rating agencies. The state, in quintessentially seeking to promote safety in the economy, delegates its supervisory power to the agencies so that investors can invest with confidence at little cost to the State. It is for this reason that regulation in this particular field is vital, and also it is vital that the regulation that is adopted does not lead to imbalances, in order to preserve that confidence. Also, the centrality of the agencies, through the dependence demonstrated by all concerned parties, means that any divergence from the agencies' stated role *will* lead to a systemic collapse, which is a clear reason for regulation in this realm.

Yet, whilst this is true and has been since the rating agencies were incorporated into the burgeoning capital markets in the mid-1970s by the SEC, the industry was not formally regulated until 2005/06, which is an incredible understanding which answers the next question posed in the introduction: what was the regulatory landscape prior to the financial crisis? The Credit Rating Agency Duopoly Relief Act of 2005 (enacted fully in 2006) and the Credit Rating Agency Reform Act of 2006 represented legislative attempts to reduce the hold the agencies had upon the marketplace. A response to their performance surrounding the Enron and WorldCom affairs, the Acts sought to increase competition in the industry and allow for the SEC to have more of an effect in an industry that it had helped to fortify. However, we saw in Chapters 1 and 4 that these Acts actually represent for us the ineffectiveness that has allowed for the agencies to continue their growth despite their appalling performance. Legislators, knowingly or not, aimed to achieve the *desired* version of events, i.e. increased competition fostering increased transparency and accuracy based on increased reputational pressure, but in doing so failed to consider the *actualities* of the ratings industry; the industry is a 'natural oligopoly' and increased competition will only raise the costs for concerned parties, which would go some way to negating the point of dealing with the ratings industry in the first place.

The financial crisis therefore represented the ideal opportunity to learn about the ineffectiveness of such an approach. Unfortunately for society, the crisis revealed that aiming to bring about the *desired* version of events without considering the *actual* dynamics of the industry can only result in ineffectiveness; the target the legislation is aiming at does not exist, so it cannot be successful. Therefore, the next question posed of what can we learn from the financial crisis about the effectiveness of pre-crisis legislation has a simple answer. The misunderstanding of the ratings industry is at the heart of the failings that led to the financial crisis. This cannot be stated enough, because the financial crisis would simply not have been possible if the rating agencies were to have performed their role as they should, a role which should have been mandated by effective and considered legislation and regulation.

In a similar vein the question of what regulatory reforms were introduced post-crisis, and what has been their effectiveness, was next to be posed in the introduction. The analysis in Chapter 4, which sought to analyse the relative section of The Dodd-Frank Act of 2010, ultimately revealed the same mistake being repeated by legislators, albeit with a slightly perverse twist. This time the legislators entrusted a large part of the reform to the SEC, an agency which has been repeatedly criticised for its role in the financial crisis, and even after the enactment of Dodd-Frank has embarked upon a CRA-friendly campaign of lenient punishments and alleged attacks upon credible opposition to the Big Three[68]. However, the biggest development was the State removing itself from the equation. Up until the enactment

[68] See 4.3 *A Reality Check* (n 46).

of Dodd-Frank there was a credible argument to be made that the failings of the rating agencies was forced upon the market by the state via regulations that forced certain parties, institutional investors or large banks for example, to use the ratings of agencies in their operational processes. Now, as a result of Dodd-Frank, that argument has been removed because any reference to the rating agencies has been struck from federal regulations. While this development has been sold as a positive for the economy, what it has done has removed any recourse for complaint from the victims of rating agency transgressions; the embeddedness of the agencies has not been reduced at all, as evidenced by their growth since the enactment of Dodd-Frank. One thing is for sure however, and that is that agencies continue to transgress even after a seemingly generation-defining legislative strike upon their business.

These transgressions were the focus of this thesis. More specifically, what allows them to continually transgress is of the utmost importance for this thesis and one reason for that continuation is revealed to be the provision of ancillary services. In answering the final question posed in the introduction, ‘how does the provision of ancillary services support the agencies’ ability to transgress, and what affect would the prohibition of ancillary service provision have upon their capacity to transgress’, Chapters 5 and 6 sought to provide a clear picture of the importance of tackling this lesser-developed line of enquiry. After being introduced to the ancillary service divisions of S&P and Moody’s in the opening section of Chapter 5, in which we saw the increasingly important contribution of the divisions to the companies’ overall health, we saw how the literature understands that the provision of additional services serves to insert pressure into the relationships the agencies have with interested parties, so that they may pressure issuers into paying for additional services via threatening to lower their ratings, or alternatively how issuers may threaten agencies with non-purchase of those additional services unless a favourable rating is granted. However, the thesis made the important contribution of adjoining the economic study of 'rent', and more specifically 'rent-harvesting', to the study of rating agency additional service provision. As a result, it became clear that the agencies incorporated the additional services in preparation for their culpable involvement in the pre-crisis securitisation process, so that they could garner excessive income from a non-essential division that would essentially protect them from the inevitable financial penalties that would ensue.

Before this thesis concludes it is worth looking forward. This thesis is operating on the claim that what is required is increased research into the actual conduct of the rating agencies, together with the increased dissemination of that critical research. So, to that end, what follows are some potential avenues for future research in this socially-important field of study.

7.1 Avenues for Further Research

Whilst there are difficulties that must be overcome if we are to have the aim of establishing reforms that prioritise the interests of the public over the interests of the private sector realised, there must be a continuation in the research to support such a move so that the calls for change become too loud to ignore. Before this thesis concludes it will be advantageous to discuss some potential avenues for future research, although it will be very important to apply the *actual v. desired* notion to the potential effects of these research ventures because what is required, more than ever, is that we seek understand the industry and its effects as it actually is, rather than what we may desire to be. To achieve this task the chapter will now provide just three potential avenues for further research under the headings of quantitative, qualitative, and normative research.

Quantitative Research

The inspiration for some potential quantitative research that may be conducted derives from the work of Jiang, Stanford, and Xie, who endeavoured to understand the impact that the issuer-pays remuneration model had upon the ratings provided by the Big Two agencies[69]. The scholars found that the issuer-pays remuneration model had a direct effect upon the ratings provided by the agencies in that the ratings rose across the board after the adoption of the model. In that same vein, the first avenue for research will be to ascertain the effect that the provision of ancillary services has upon the ratings given by the agencies to the procurers of the additional services.

However, whilst the records are readily available to show who purchased the additional services at what time, which could then be matched to the purchasing of a credit rating, there are a number of issues that would have to be considered. Firstly, one of the claims regarding the issues with the provision of additional services is that the purchasing of the services serves to protect the issuer's rating, so in this sense the effect could not be seen in the findings; one would see the purchase of the additional services but no change in the rating, which means that one would have to make the assumption that there is an influence which is something that can be done without the quantitative research. Secondly, the effect of the purchasing of ancillary services may not be immediate, so one would have to decide on a timeframe as to when the change in rating may take place so as to point towards the presence of influence stemming from the purchasing of additional services. There is enough scope to conduct this research which would prove a valuable addition to the calls for prohibition,

[69] See 3.3.2 *The Effects of the Issuer-Pays Remuneration Model* (n 88).

although another aspect is that the *perceived* conflict alone is enough to call for the prohibition, so the benefit of such quantitative research would be welcome but still limited.

Qualitative Research

Qualitative research has the potential of being very useful indeed, with the caveat being that the subjects of the research would have to disclose their honest opinions. What the field needs to know is the purchaser's opinions on the value of the additional services that are offered by rating agencies, and in what particular element that value lays. An example of the research that could be conducted would be the development of a questionnaire, or set of questions to be asked in an interview, all on the basis of anonymity, that could be given to a sample of leading management figures within the leading purchasers of additional services over a given time period. Questions may take the form of ascertaining why their company purchases the services, what effect the services have upon their ability to compete, their personal view on the connection between the services and the rating services, and whether or not they believe the purchasing of additional services has an impact upon their credit rating.

However, there is one outstanding issue here and that is to do with incentive. It is reasonable to assume that leading management figures within these large companies would have very little incentive to provide incriminating details, or even thoughts, against the agencies, even on the basis of anonymity. This is mostly because, as was mentioned earlier, the prohibition of additional services removes the potential for issuers to pressure rating agencies into awarding a rating higher than what is deserved, which we saw was at the heart of the Financial Crisis. Whereas rating agencies have decided they have no stake in the advancement of society, the same sentiment can equally be ascribed to other parts of the financial sector, with issuers of structured-finance products being particularly callous in their regard for the advancement of society; this element would need to be considered before one began this research – is the probability of obtaining honest information high enough?

Normative Research

The last avenue for future research that is being advanced by thesis is concerned with the continuation of the study of the difficulties of regulating financial cartels, cartels that are usually the result of government intervention. This normative research is incredibly abstract, simply because of the obvious negative outcome from the statement; it is obviously very difficult to regulate financial cartels that the State has helped to create i.e. the ratings oligopoly or the banking cartel.

Therefore, what is required is that one must look at some small element of this issue and focus upon that in order to attempt to make some incremental advances in the battle against financial cartels. In a similar vein to this thesis, calls for action against such powerful entities must be based upon simplistic but real analyses, so that opposition to the endeavour can be categorised as part of the problem. The first step in these analyses would be to provide enough evidence to quash any argument regarding the socially destructive *nature* of the given industry; this is important because an understanding of the inherent nature of the given industry means that any calls to compromise and work alongside the industry can be dismissed as passive and potentially collaborative, revealing the position of that particular entity. Once this evidence is established, the next aim would be to present a simplistic reform proposal based upon the same ideals as the *actual v. desired* framework so that the reform has the potential of being impactful.

All in all the aim of any future research must be to focus upon the reality whenever possible. This thesis has demonstrated that regulating an embedded entity based upon illusory beliefs regarding the capacity of the target will only lead to failure. Whether future research looks at the banking, credit rating, accounting, insurance, or shadow-banking industry, to name but a few, the application of an analysis that is rooted in reality is the only chance of attaining truly impactful change; it is this type of change that will positively affect society, nothing else will do.

7.2 'Consequences'

"This historic settlement makes clear the consequences of putting corporate profits over honesty in the financial markets"

The statement above represented the opening of the thesis and it is fitting that it represents the closing as well. Towards the end of the thesis a conscious decision was made to examine the potential future ahead, in terms of looking at what may be achieved, and how we may go about doing so. Conducting critical research and then disseminating that research widely, so that the public can be more aware of the system that is costing them so much, is a particularly worthwhile endeavour and one that this thesis hopes to represent. However, the potential effect of that research will only come to fruition if we as researchers are brutally honest with our critique. The statement above says that the historic settlement makes clear the *consequences* of putting corporate profits over honesty, and it is absolutely correct. The historic settlement makes absolutely clear that there are no real consequences to putting corporate profits over honesty in the financial realm. To punish fraud, committed by divisions within S&P that have clear organisational structures so that we know who made the decisions to defraud millions of investors, with a $1.375 billion fine when the profits earned from their fraud outweigh that fine, and then some, sends a clear message to anyone else wondering whether they can get away with fraud in the financial sector in future upturns. The focussing upon aspects of the rating industry that stand no chance of reducing their capability to transgress not only sends a clear message to the agencies that their transgressions can continue unabated, but should send a message to all of us that the system as it currently operates does not do so in the name of protecting citizens.

If we are to see a world in which the protection of the citizen is considered in economic policy, which it should be given the centrality of the economy to modern society, then a period of *concerted* social campaigning is what is required. That is not to say that one must reject their views on how the system should operate entirely, but we must all primarily seek to eliminate the social ills that financial catastrophes create. It is simply not justifiable that the rate of suicides, homelessness, unemployment, disease, and familial breakdown should increase because of the quest for *excessive* profits by multinational firms. This thesis has no qualms with the idea of profit, or the quest for it, but it should be stated emphatically that the quest for profit *at all cost* is not capitalism, it is greed. It is not something to be lauded, it is something to condemn. It is, essentially, something that we must aim to constrain, or better still eradicate, if society is to move forward. *Placing any other values at the forefront of our thinking will only lead to the continuation of the system that, in 2007/08, left a lasting and destructive mark upon society.*

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